MISSISSIPPI LAW JOURNAL

SYMPOSIUM ON THE UNIFORM COMMERCIAL CODE

Revised Article 8 of the Mississippi UCC: Dealing Directly with Indirect Holding
Bryn R. Vaaler

Modernizing Commercial Financing Practices: The Revisions to Article 5 of the Mississippi UCC
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Ethical Considerations in Appointment and Compensation of An Attorney for a Chapter 11 Debtor-in-Possession
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The Impact of Dilution in Asset Securitization: Commercial Separation Anxiety
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CLAYTON LAW JOURNAL SUITE

Thad Cochran[*]

Hugh N. Clayton, editor of Volume III of the *Mississippi Law Journal* during 1930-1931, and his son, Hugh C. "Buzzy" Clayton, editor of Volume XLI forty years later, were the first father and son pair to serve the *Journal* as Editor-in-Chief.

A ceremony was organized by Editor Scott R. Hendrix on October 15, 1996, at Ole Miss to celebrate the installation of a new bronze marker on the entrance to the offices of the *Journal* and to rededicate the suite to the Claytons' memory.

Speaking for the University and the School of Law on this occasion, Chancellor Robert C. Khayat and Acting Dean William M. Champion recalled the unique qualities of intellect, character, personality and accomplishment that made Hugh and Buzzy Clayton such excellent choices for this special recognition.

Not only did the coincidence of their tenure as editors justify this honor but the esteem and affection in which they were held and continue to be remembered by those who knew them compel us to hold them up as examples worthy of emulation by all who are chosen to serve as members of the staff of the *Mississippi Law Journal*.

Their contributions to the *Journal*, the School of Law, and the University are only a part of the story of their lives of service, citizenship, and leadership. I am confident that all who have had the honor to help edit and publish the *Journal* will feel even more honored to be identified in this special way with Hugh and Buzzy Clayton.

---

[*] United States Senator for the State of Mississippi, 1978 to present. United States Representative for the State of Mississippi, 1973 to 1978. B.A. 1959, J.D. 1965, University of Mississippi. Senator Cochran served as Articles Editor of the *Mississippi Law Journal* from 1964 to 1965.

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REVISED ARTICLE 8 OF THE MISSISSIPPI UCC: DEALING DIRECTLY WITH INDIRECT HOLDING

Bryn R. Vaaler[*]

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[*] The author, an Associate Professor of Law at the University of Mississippi, gratefully acknowledges the research assistance of Kurt Kaple and Amy Kebert Elder.

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I. INTRODUCTION

On April 3, 1996, Governor Kirk Fordice signed Senate Bill 2735,[1] adopting into Mississippi law Revised Article 8 of the Uniform Commercial Code (UCC) and related amendments to Articles 1, 4, 5, 9, and 10.[2] The revisions in Senate Bill 2735 are the result of more than five years of effort led by the sponsors of the UCC: the National Conference of Commis-

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[1] S. 2735, 1996 Leg., Reg. Sess., 1996 Miss. Laws 468. The author is a member of the Business Law Advisory Group serving Mississippi Secretary of State Eric Clark. The Group advises the Secretary of State on legislative and rulemaking initiatives in the corporate, securities, and commercial areas. It is made up of selected personnel from the Secretary of State's office, prominent practitioners from around the state, and professors from the state's two law schools. The Business Law Advisory Group initiated and promoted the legislation that became Senate Bill 2735. The author served as reporter to the Business Law Advisory Group on this legislation.

[2] *See* REVISED (1994) ARTICLE 8 INVESTMENT SECURITIES (WITH CONFORMING AND MISCELLANEOUS AMENDMENTS TO ARTICLES 1, 3, 4, 5, 9,. AND 10), *reprinted in* UNIF. COMMERCIAL CODE 2C U.L.A. 38-148 (Supp. 1996) [hereinafter REVISED ARTICLE 8 OFFICIAL TEXT]. Mississippi's version of the UCC is found in Chapters 1 through 11 of Title 75 of the Mississippi Code. *See* MISS. CODE ANN. §§ 75-1-101 to -11-108 (1972 & Supp. 1996) (codifying the Mississippi UCC); *id.* §§ 75-8-101 to -406 (codifying Revised Article 8). Where distinctions between the various generations of Article 8 are necessary, this article refers to (a) the latest version of Article 8 as Revised Article 8, (b) its immediate predecessor as the 1978 version, and (c) the version in existence from original adoption until the 1978 revision as original Article 8.

sioners on Uniform State Laws (NCCUSL) and the American Law Institute (ALI).[3] The primary purpose of the revision was

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[3] In a sense, the revision process began with the October 19, 1987 stock market crash and was spurred on by the threat of federal preemption. The history of the revision process is outlined by Professor James Steven Rogers, who served as reporter of the Revised Article 8 project for the NCCUSL/ALI drafting committee:

> In a number of the studies issued after the October 1987 stock market break, it was suggested that uncertainties about the application of the commercial law rules found in old Article 8 to the modern system of securities holding through intermediaries might operate as an impediment to efforts to control or limit risks in times of disturbances in the securities and financial markets. In October 1988, the Chairman of the SEC requested that the American Bar Association (ABA) undertake a study of the need for revisions of Article 8 and related provisions of bankruptcy law. In response, the Business Law Section of the ABA formed an Advisory Committee on Settlement of Market Transactions. In February of 1991, the ABA committee issued an interim report that made tentative recommendations for revision of Article 8 and various provisions of the federal Bankruptcy Code. At the same time that the ABA Committee was at work, the United States Congress was considering various legislative packages for amendments to the federal securities laws in response to the October 1987 market break and the failure of Drexel Burnham in February of 1990. Recognizing the need for revision in the commercial law foundation of the securities holding system, as well as the concern that revision of commercial law by the uniform state laws process might not be feasible, Congress gave the SEC the authority to promulgate federal regulations that would preempt state law on the transfer and pledge of securities if the SEC finds, after recommendations of an Advisory Committee and consultation with the Secretary of the Treasury and Board of Governors of the Federal Reserve System, that the absence of a uniform federal rule substantially impedes the safe and efficient operation of the national system for clearance and settlement of securities transactions. In response to these developments, NCCUSL and the ALI formed a drafting committee in the spring of 1991 and directed the committee to proceed as quickly as possible with the work of revising Article 8 to meet the needs identified in these various studies.

James Steven Rogers, *Policy Perspectives on Revised U.C.C. Article 8*, 43 UCLA L. REV. 1431, 1445-47 (1996) [hereinafter *Policy Perspectives*]; *see also* DIVISION OF MARKET REGULATION, SEC, THE OCTOBER 1987 MARKET BREAK *passim* (1988) (leading study of clearance and settlement problems in 1987 market break) [hereinafter 1987 MARKET BREAK]. In light of promulgation of Revised Article 8, the SEC has not exercised its power to adopt preemptive rules under the Coordinated Clearance and Settlement Act of 1990. H.R. Res. 477, 101st Cong. (1990) (enacted).

The process leading to adoption of Revised Article 8 has been accompanied, analyzed, and urged on by numerous scholarly and professional articles by Professor Rogers and others. *See, e.g.*, Egon Guttman, *U.C.C. D.O.A.; Le Roi Est Mort,*

to make the basic commercial and property law rules in the UCC governing transfers and pledges of investment securities better reflect the realities of modern U.S. securities markets, most notably, the system of indirect holding of securities which has come to dominate the U.S. public securities markets over the last three decades.[4]

From the time of its final promulgation in 1994 through January 1997, Revised Article 8 (with related amendments) had been adopted in twenty-eight states in addition to Mississippi.[5] Article 8 is now the first UCC article to have gone through three complete generations of revision.[6]

Article 8 and its related sections in the UCC provide the basic commercial and property law rules governing transactions in investment securities and security interests therein: the nuts-and-bolts of securities transfers and pledges. Con-

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Vive Le Roi, 26 LOY. L.A. L. REV. 625 (1993); Charles W. Mooney, Jr. et al., *An Introduction to the Revised U.C.C. Article 8 and Review of Other Recent Developments with Investment Securities*, 49 BUS. LAW. 1891 (1994); Charles W. Mooney, Jr., *Beyond Negotiability: A New Model for Transfer and Pledge of Interests in Securities Controlled by Intermediaries*, 12 CARDOZO L. REV. 305 (1990) [hereinafter *Beyond Negotiability*]; James S. Rogers, *An Essay on Horseless Carriages and Paperless Negotiable Instruments: Some Lessons From the Article 8 Revision*, 31 IDAHO L. REV. 689 (1995) [hereinafter *Horseless Carriages*]; Jeanne L. Schroeder, *Is Article 8 Finally Ready This Time? The Radical Reform of Secured Lending on Wall Street*, 1994 COLUM. BUS. L. REV. 291 (1994); James Steven Rogers, *Behind the Article 8 Ball: The Law Plays Catch-up with Indirect Securities Holding*, 4 BUS. L. TODAY 44 (Jan.-Feb. 1994) [hereinafter *8 Ball*]; James Steven Rogers, *Revised UCC Article 8: Why It's Needed, What It Does*, C965 A.L.I.A.B.A. 285 (1994) [hereinafter *Why It's Needed*].

[4] *See* REVISED ARTICLE 8 OFFICIAL TEXT, *supra* note 2, at 39 ("The present version of Article 8 is the product of a major revision made necessary by the fact that the prior version of Article 8 did not adequately deal with the system of securities holding through securities intermediaries that has developed in the past few decades.").

[5] Revised Article 8 had been adopted, as of January 15, 1997, in Alaska, Alabama, Arizona, Arkansas, California, Colorado, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maryland, Massachusetts, Minnesota, Mississippi, Nebraska, New Mexico, Oklahoma, Oregon, Pennsylvania, Texas, Utah, Vermont, Virginia, Washington, West Virginia, and Wyoming. Revised Article 8 has also been adopted in Puerto Rico and the District of Columbia. UNIF. COMMERCIAL CODE § 8-101 note, *reprinted in* 2C U.L.A. 65-67 (Supp. 1997). *See also* Ruth E. Olson et al., *Review of Recent Developments in U.C.C. Article 8 and Investment Securities*, 51 BUS. LAW 1441, 1441 n.2 (1996).

[6] *See* Rogers, *Horseless Carriages*, *supra* note 3, at 690.

tract, agency, federal and state securities, corporate, and numerous other bodies of law govern the agreements of parties buying and selling securities, their relationships with broker-dealers and other securities intermediaries, the disclosures made to the parties, and the parties' ultimate rights as security holders of the issuer. Article 8 and its related sections govern the mechanics of consummating such agreements.[7] They detail the what, when, and how of transfer of ownership and of attachment, perfection, and priority of security interests. In the public securities markets, the focus of Article 8 is therefore not on the trading itself,[8] but on the mechanics of consummating the exchange of securities and cash as promised in the trading:[9] the process known as "clearance and settlement."[10]

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[7] Article 8 plays a narrowly focused, but crucial, role in the complex legal environment in which U.S. securities markets operate:

> [Article 8 is] one part of the mosaic of laws under which securities are bought, sold, and pledged. State corporate and contract law establish the rights that owners of equity and debt securities have against issuers. Federal and state securities laws govern disclosure of financial information about issuers of securities and regulate the activities of broker-dealers and other participants in the securities markets. Article 8 is different. It sets the ground rules for implementing transfers and resolves disputes that may arise when different people claim conflicting interests.
>
> By way of rough analogy, one might think of Article 8 as playing the role for securities that the recording acts play for real estate. Real estate recording acts tell you how to transfer interests in real estate, but they don't tell you what it means to own real estate nor do they regulate the conduct of parties to real estate transactions.

Rogers, *Why It's Needed, supra* note 3, at 287.

[8] *See* REVISED ARTICLE 8 OFFICIAL TEXT, *supra* note 2, at 46.

[9] *See* Rogers, *Policy Perspectives, supra* note 3, at 1439 ("[I]t is common to think of the securities exchanges and markets as the mechanisms through which securities are transferred from party to party. In a general sense, of course, that is true; but to be precise, one must realize that the traders in the securities exchanges and markets are not buying and selling securities — at least not in the sense of exchanging securities for money — they are entering into *contracts* for the purchase and sale of securities.").

[10] *See* Rogers, *Policy Perspectives, supra* note 3, at 1439 ("The phrase 'clearance and settlement' refers to the process by which the securities and cash are actually exchanged in performance of the contracts entered into by the trading process"). A more precise definition of the terms would be as follows:

> "Clearing," "clearance," or "trade comparison" refers to the comparison or reconciliation of what a trade was; that is, a posttrade comparison by the involved parties confirming (1) that the trade was executed, and (2)

Original Article 8 was drafted beginning in the 1940s based on the paradigm of delivery and possession of physical certificates as the key elements in consummating a transfer of ownership or hypothecation of securities.[11] Delivery of a physical certificate (with proper endorsements) traditionally marked a change in ownership. Possession of a physical certificate traditionally evidenced ownership of a security or a security interest therein. The physical-delivery-and-possession metaphor reflected the predominant commercial reality in the U.S. public securities markets at the time Original Article 8 was first conceived; and, it still reflects commercial reality in the transfer and pledge of stock of most privately held corporations. The predominant commercial reality in the U.S. public securities markets, however, began rapidly moving away from the paradigm of the physical certificate directly held by the owner or secured creditor by the 1960s. As transaction volume exploded in the public markets in the 1960s, certificate-based clearance and settlement became hopelessly swamped in a Wall Street back-office "paper crunch."[12] The

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that it was executed in accordance with the directions of the buyer and seller. "Settlement" is the actual exchange of securities and payment.

6 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 2908-09 (3d ed. 1990); *see also* Ralph C. Ferrara & Konrad S. Alt, *Immobilization of the Security Certificate: The U.S. Experience,* 15 SEC. REG. L.J. 228, 230-35 (1987) (outlining step-by-step process of clearance and settlement).

Prior to June 7, 1995, settlement typically occurred five business days after the date on which a stock trade occurred (such timing being referred to in the securities industry as "T+5"). Effective June 7, 1995, the SEC adopted Rule 15c6-1 under the Securities Exchange Act of 1934, which requires that settlement normally occur by the third business day after the trade date ("T+3"). 17 C.F.R. § 240.15c6-1 (1996); *see also* Securities Act Release No. 7022, [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,232, at 85,232 (Oct. 6, 1993).

[11] REVISED ARTICLE 8 OFFICIAL TEXT, *supra* note 2, at 39.

[12] *See* Schroeder, *supra* note 3, at 310. Schroeder notes that:

> In the 1960s, securities were transferred in the way [Original Article 8] contemplates. Whenever a trade was made, messengers ran back and forth between the "back offices" of the broker-dealers delivering certificates. The great bull market of the 1960s resulted in what was known as the "paper crunch." Securities trading practice in the 1960s was so paper intensive the industry literally could not keep up. Things had gotten so out of hand by 1968 that when trades on the New York Stock Exchange rose to the then unheard of volume of ten million per day, the

system of direct holding of physical certificates (in which every trade required a movement of certificates, endorsements, and related paperwork for intermediaries, issuers, and transfer agents) proved too cumbersome and slow to remain the dominant system of clearance and settlement.

One theoretical approach to alleviating the paper crunch seemed obvious to some: eliminate paper certificates and go to a system of direct registration of security holders and secured lenders on the records of the issuer.[13] In an effort to anticipate the direction that the public markets would take to cope with the back-office paper glut, NCCUSL and the ALI revised Article 8 in 1978 to provide a parallel set of rules for transactions and security interests in uncertificated securities: securities represented by no physical certificate, the ownership and transfer of which would be marked simply by registration on the records maintained by the issuer or its transfer agent.[14]

> Exchange first began closing two hours early, and finally remained closed all day every Wednesday just so members could catch up with the paper work needed to close trades. Several notable broker-dealers failed. Consensus grew in the securities industry and the commercial bar that the system was in crisis.

Schroeder, *supra* note 3, at 310.

An SEC study engendered by the paper crunch described Wall Street methods for effecting deliveries and transfers at the time as "positively archaic" and calculated that a typical individual investor buy order during the 1960s required a brokerage firm to use thirty-three different documents to execute and record the transaction, all of which was done manually. SEC, STUDY OF UNSAFE AND UNSOUND PRACTICES OF BROKERS AND DEALERS, H. Doc. No. 92-231, at 165 (2d Sess. 1971); *see also* 6 LOSS & SELIGMAN, *supra* note 10, at 2897-2914 (containing overview of paper crunch and its effects); *see also* REVISED ARTICLE 8 OFFICIAL TEXT, *supra* note 2, at 39.

[13] *See* REVISED ARTICLE 8 OFFICIAL TEXT, *supra* note 2, at 39-40.

[14] REVISED ARTICLE 8 OFFICIAL TEXT, *supra* note 2, at 39-40. For a description of the transfer of uncertificated securities and creation of security interests therein under the 1978 version of Article 8, see EGON GUTTMAN, MODERN SECURITIES TRANSFERS ¶¶ 5.02-.03[3][b] (3d ed. 1987); Egon Guttman, *Toward the Uncertificated Security: A Congressional Lead for States to Follow*, 37 WASH. & LEE L. REV. 717, 735-37 (1980). Professor Jeanne Schroeder offers a philosophical critique of the logic leading to the uncertificated securities amendments:

> The drafters of the [1978 version] made the classic error: reinstatement through simple negation. They were so transfixed by physicality that they fixated on the physical certificate. This led to a series of increasingly complex conflations. They conflated the property right in the *res* with

Although some segments of the public securities markets[15] adopted a system of uncertificated securities and direct registration, the ever-expanding trading volume moved the market toward a system that not only eliminated the movement of paper certificates, but also eliminated the need to deal with the issuer or its transfer agent in order to consummate every trade.[16]

> the *res* itself, conflated the intangible *res* (i.e., the security) with the tangible token evidencing the *res* (i.e., the certificate), and conflated physical custody of the token with both beneficial and record ownership of the underlying *res*. As a result, the drafters thought they could change the conveyancing regime merely by changing the form of the evidentiary token. They did not stop and reexamine the other presumptions underlying the statutory schema.
>
> Consequently, they thought that the innovation that would revolutionize the securities industry was the "uncertificated security"—a new form of investment product that would not require a certificate, but would be evidenced only on the books of the issuing company. At first glance, this seemed to offer some hope since it would return securities ownership back to its nineteenth century form prior to reification through the adoption of negotiable securities certificate statutes. This should have allowed the drafters to start afresh from a mid-twentieth century standpoint unburdened with nineteenth century qualms about the assignability of intangibles. Instead, the drafters of [the 1978 version] brought with them all of the baggage of traditional negotiable certificate law and reification theory. In other words, they retained all of the conceptual and practical problems of certificated securities, without the intuitive simplicity of the certificate itself. Fictive physicality was to replace actual physicality.

Schroeder, *supra* note 3, at 311-12. Mississippi adopted the 1978 version of Article 8 in 1990. 1990 Miss. Laws 384.

[15] The primary segment of the corporate securities market in which uncertificated shares and direct registration have become the norm is the mutual fund segment. *See* REVISED ARTICLE 8 OFFICIAL TEXT, *supra* note 2, at 40 ("Mutual funds shares have long been issued in uncertificated form, but virtually all other forms of publicly traded corporate securities are still issued in certificated form."); Jeanne L. Schroeder & David Gray Carlson, *Security Interests under Article 8 of the Uniform Commercial Code,* 12 CARDOZO L. REV. 557, 559-60 (1990) ("In fact, the uncertificated security never caught on. With the exception of open end mutual funds, hardly any companies intentionally use them."). Government securities have also operated on an uncertificated basis in recent decades. GUTTMAN, MODERN SECURITIES TRANSFERS, *supra* note 14, ¶ 1.04[2], at 32 & n.106.

[16] An additional problem with the uncertificated securities system was that state corporation statutes did not generally provide for uncertificated stock at the time the 1978 version of Article 8 was being promoted and revision of state cor-

Instead of moving toward direct registration of uncertificated securities, the U.S. public securities markets devised the indirect holding system.[17] In the indirect holding system, paper certificates still exist, but they are not registered in the name of the customers who beneficially own them.[18] Certificates are, instead, held in street or nominee name on behalf of the ultimate beneficial owners by broker-dealers, banks, or a depository in which the broker-dealers and banks are participants, such as The Depository Trust Company (DTC).[19] A customer's beneficial ownership in the securities held in street or nominee name by the broker-dealer, bank, or depository is represented by bookkeeping entries in the customer's account at the broker-dealer or bank having the customer relationship with the beneficial owner. Transfers of ownership and interests in the securities indirect-

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poration statutes to so provide was a slow process. *See* GUTTMAN, MODERN SECURITIES TRANSFERS, *supra* note 14, ¶ 1.04[2]. Section 6.26 of the 1984 Revised Model Business Corporation Act provided for uncertificated stock; and, many corporation statutes had followed suit by the mid-1980s. *See* GUTTMAN, MODERN SECURITIES TRANSFERS, *supra* note 14, ¶ 1.04[2]. The Mississippi Business Corporation Act, which is based on the Model Business Corporation Act, was amended in 1990 to include the Model Act provisions dealing with uncertificated shares of stock. 1990 Miss. Laws 47. *See* MISS. CODE ANN. § 79-4-6.26(a) (1996) ("Unless the articles of incorporation or bylaws provide otherwise, the board of directors of a corporation may authorize the issue of some or all of the shares of any or all of its classes or series without certificates.").

[17] For an overview of the indirect holding system, see *infra* notes 40-74 and accompanying text.

[18] Article 8 refers to the security holder whose name appears on the certificate representing the security and on the corresponding records of the issuer as the "registered" holder or "registered" owner. *See, e.g.*, U.C.C. §§ 8-102(13), 8-301 (1996). Corporate law has traditionally referred to such security holder, at least in the context of stock, as the "record" holder or the "record" owner. *See, e.g.*, DEL. CODE ANN. tit. 8, § 213 (1991); AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE § 1.32 (1992). *But see* REVISED MODEL BUS. CORP. ACT § 1.40(22) (1984) (defining "shareholder" as "the person in whose name shares are *registered* in the records of a corporation." (emphasis added)). This article uses the terms "registered" and "record" interchangeably.

[19] DTC holds securities in the nominee name "Cede & Co." DTC is "a limited purpose trust company organized under New York law for the purpose of acting as a depository to hold securities for the benefit of its participants, some 600 or so broker-dealers and banks." REVISED ARTICLE 8 OFFICIAL TEXT, *supra* note 2, at 40. For further description of the role of DTC in the indirect holding system, see *infra* notes 44-53 and accompanying text.

ly held can be accomplished through bookkeeping entries rather than physically delivering certificates and changing registration on the records of the issuer or its transfer agent. At the end of a trading day, the bookkeeping entries for all the trading by indirect holding customers at each broker-dealer can be totalled and the net receive or deliver obligation of such broker-dealer in each particular security traded can be determined with respect to every other broker-dealer.[20] Clearing can then be accomplished among participants in a common depository, like DTC, by making corresponding adjustments to the depository's books to effect the net change in position for each participant for each security traded.[21] The vast majority of all publicly traded securities are currently held indirectly through this multi-tiered system of street or nominee name ownership.[22] By eliminating physical handling and delivery of paper and relegating clearance and settlement to a bookkeeping process, the indirect holding system has permitted back-office functions to become almost entirely a matter of computer automation. As technology has advanced, the efficiencies afforded by this predominant system of immobilized certificates and netted bookkeeping entries has permitted the clearance and settlement process to keep up with the enormous trading volume of the 1980s and 1990s.[23]

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[20] This netting function is carried out by the National Securities Clearing Corporation (NSCC). For further discussion of the role of NSCC in the indirect holding system, see *infra* notes 68-74 and accompanying text.

[21] REVISED ARTICLE 8 OFFICIAL TEXT, *supra* note 2, at 40.

[22] *Id.*

[23] Rogers, *Horseless Carriages, supra* note 3, at 691. Rogers discusses the paper crunch noting that:

> At the time of the "paper crunch" in the late 1960s, the trading volume on the New York Stock Exchange that so seriously strained the capacities of the clearance and settlement system was in the range of 10 million shares per day. Today, the system can easily handle daily trading volume on routine days of hundreds of million shares. Even during the October 1987 market break, when daily trading volume reached the current record level of 608 million shares, the clearance and settlement system functioned relatively smoothly. Obviously this processing capacity could have been achieved only by the application of modern electronic information processing systems, and that is the case. Physical delivery of certificates plays only a minor role in the settlement system that pro-

Although the 1978 version of Article 8 had some provisions dealing with indirectly held securities, they were grafted on to a structure designed around direct ownership of certificated or uncertificated securities.[24] Revised Article 8, which supplants the 1978 version in its entirety, continues to provide for the direct holding system but also deals directly with the *indirect* holding system that today dominates the U.S. public securities markets. Revised Article 8 is divided into five parts. Part 1 contains key definitions and definitional concepts.[25] Parts 2, 3, and 4, which deal with directly held securities (both certificated and uncertificated), retain the basic conceptual structure and rules of the 1978 version, with some important simplifications and improvements.[26] Part 5 deals with the indirect holding system. The provisions of Part 5 describe the package of rights of a person who holds a security indirectly through an intermediary.[27] Under Revised Article 8, this package of rights is defined as a "security entitlement."[28] In addition to describing the rights that make up a security entitlement, Part 5 provides a comprehensive set of rules regarding when a security entitlement is acquired, adverse claims against the entitlement holder and other essential matters that cover the same ground as Parts 2, 3, and 4 cover for the direct holding system.[29]

Revised Article 8 and its related revisions also overhaul the rules on security interests in investment securities, moving the essential provisions on attachment and perfection out

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> cesses this enormous volume of securities trading. Yet the legal rules under which the system operates are not the uncertificated securities provisions of Article 8 that were drafted in response to the obvious fact that the paper-based system had to be replaced by an electronic system.

Id. at 691.

[24] *See* Rogers, *Policy Perspectives, supra* note 3, at 1447.

[25] *See infra* notes 133-73 and accompanying text.

[26] *See infra* notes 174-225 and accompanying text.

[27] *See infra* notes 109-22 and accompanying text.

[28] Security entitlement is defined in Revised Article 8 as "the rights and property interest of an entitlement holder with respect to a financial asset specified in Part 5." U.C.C. § 8-102(a)(17) (1996); *see also infra* notes 109-22 and accompanying text.

[29] *See infra* notes 226-34 and accompanying text.

of Article 8 (where they had been transplanted in the 1978 revision) and back to Article 9 along side the provisions on priority.[30] Revised Article 9 deals directly with the indirect holding system by recasting the requirements for attachment and perfection and the criteria for priority in terms that can accommodate not only directly held securities but also security entitlements.[31] Essential to this revision is the concept of "control."[32] The basic rule in section 9-115 of revised Article 9 is that a security interest in investment securities may be perfected by control and that a secured lender with control has priority over a secured lender who does not have control.[33] Obtaining control means taking the steps necessary to place the lender in a position where it can have the collateral sold off without the further cooperation of the debtor.[34] For certificated securities, this may be accomplished by possession of the certificate with necessary endorsements, the traditional possessory pledge.[35] The new concept of control, however, goes beyond the traditional physical metaphor. For a security entitlement, a lender may obtain control either by becoming the entitlement holder or by obtaining the agreement of the securities intermediary having the customer relationship with the debtor that the intermediary will act on the instructions of the

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[30] *See infra* notes 235-96 and accompanying text.

[31] The revised provisions of Article 9 govern security interests in a newly defined category of collateral: "investment property." Investment property is defined in revised Article 9 to include not only certificated and uncertificated securities and security entitlements, which are covered by Revised Article 8, but also commodities investments and accounts which are not covered by Revised Article 8. U.C.C. § 9-115 (1996); *see also infra* notes 128-32 and accompanying text.

[32] U.C.C. § 8-106(a)-(g) (1996); *see also infra* notes 246-71 and accompanying text.

[33] *See infra* notes 278-96 and accompanying text.

[34] U.C.C. § 8-106 cmt. 1 (1996). "Obtaining 'control' means that the purchaser has taken whatever steps are necessary, given the manner in which the securities are held, to place itself in a position where it can have the securities sold, without further action by the owner." *Id.*

[35] *Id.* § 8-106(b). "A purchaser has 'control' of a certificated security in registered form if the certificated security is delivered to the purchaser, and: (1) the certificate is indorsed to the purchaser or in blank by an effective indorsement; or (2) the certificate is registered in the name of the purchaser, upon original issue or registration of transfer by the issuer." *Id.*; *see also infra* notes 247-49 and accompanying text.

lender.[36]

This article provides a brief introduction to Revised Article 8 for the Mississippi practitioner. It is not intended to provide anything approaching a comprehensive review of this complex and somewhat arcane body of law.[37] Article 8 is one of the least familiar territories in the realm of corporate, commercial, and securities law.[38] Although it plays a pivotal role in securities and secured lending transactions of enormous economic consequence, few lawyers need actually apply it on a day-to-day basis or understand its intricacies.[39] In a way, Article 8 is like a complex electronic component I intend to upgrade in my personal computer. I do not need to know precisely how it works inside, but I do need to know its basic function, where it fits in the overall structure of things, why it needed revision or upgrading, and under what circumstances I may need to learn more. With that purpose in mind, Part II of this article describes the basics of the indirect holding system in the U.S. public securities markets. Part III outlines the provisions of Revised Article 8 and the related revisions to Article 9, focusing on the changes being made to the provisions dealing with directly held securities and the new framework for security entitlements. Part IV concludes with a brief discussion of the benefits of the revisions for Mississippi and

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[36] U.C.C. § 8-106(d) (1996); *see also infra* notes 259-64 and accompanying text.

[37] The best comprehensive explanation of Revised Article 8 is in the prefatory note and commentary to REVISED ARTICLE 8 OFFICIAL TEXT, *supra* note 2. See Rogers, *Policy Perspectives*, *supra* note 3, at 1433, 1545 n.2.

[38] *See* Rogers, *Policy Perspectives*, *supra* note 3, at 1432 ("Article 8 is one of the more recondite branches of commercial law. Neither the generalist practicing lawyer nor the commercial law expert is likely to feel comfortable with this subject. Article 8 is not commonly taught in law school commercial law courses and is omitted or given scant coverage in the principal secondary sources on commercial law. Even among the initiates, the particular concerns that led to the 1994 revision project are the major arcana of the field").

[39] Mississippi case law on Article 8 is practically nonexistent. A WESTLAW search conducted in December 1996 revealed only one Mississippi Supreme Court decision dealing substantively with Article 8. In *Thomas v. Prewitt*, the supreme court interpreted the statute of frauds provision applicable to contracts for the sale of investment securities in section 8-319 of Original Article 8. Thomas v. Prewitt, 355 So. 2d 657 (Miss. 1978). The statute of frauds provision applicable to contracts for the sale of investment securities has been eliminated in Revised Article 8. *See infra* notes 170-73 and accompanying text.

the rest of the country.

II. INDIRECT HOLDING OF SECURITIES IN THE U.S. PUBLIC MARKETS

The indirect holding system in the U.S. public securities markets is like a pyramid.[40] At the top of the pyramid is The Depository Trust Company (DTC), which holds securities primarily in its nominee name "Cede & Co.," along with the other, smaller common depositories created to hold securities on behalf of participant intermediaries.[41] At the bottom of the pyramid are the ultimate beneficial owners of the securities—institutional and individual investors. In between the top and the bottom tiers of the pyramid are the various securities intermediaries,[42] beginning, at the bottom, with the broker-dealer or bank that has the actual customer relationship with

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[40] *See* REVISED ARTICLE 8 OFFICIAL TEXT, *supra* note 2, at 41 ("The principal mechanism through which securities trades are settled today is not delivery of certificates or registration of transfers on the issuer's books, but netted settlement arrangements and accounting entries on the books of a multi-tiered pyramid of securities intermediaries").

[41] REVISED ARTICLE 8 OFFICIAL TEXT, *supra* note 2, at 41; *see also* HAROLD S. BLOOMENTHAL & HOLME ROBERTS & OWEN, SECURITIES LAW HANDBOOK 973 (1995); *infra* notes 54-57 and accompanying text. DTC and the other common depositories are "clearing agencies" within the meaning of section 3(a)(23) of the Securities Exchange Act of 1934. 15 U.S.C. § 78c(a)(23)(A) (1994). This term includes:

> [A]ny person, such as a securities depository, who . . . acts as a custodian of securities in connection with a system for the central handling of securities whereby all securities of a particular class or series of any issuer deposited within the system are treated as fungible and may be transferred, loaned, or pledged by bookkeeping entry without physical delivery of securities certificates . . . or otherwise permits or facilitates the settlement of securities transactions or the hypothecation or lending of securities without physical delivery of securities certificates.

6 LOSS & SELIGMAN, *supra* note 10, at 2914. Under Revised Article 8, these depositories are "clearing corporations," which are defined as including clearing agencies under the federal securities laws as well as a federal reserve bank (which is carved out of the federal securities law definition). U.C.C. § 8-102(a)(5) (1996).

[42] Revised Article 8 defines "securities intermediary" as "(i) a clearing corporation; or (ii) a person, including a bank or broker, that in the ordinary course of its business maintains securities accounts for others and is acting in that capacity." *Id.* § 8-102(a)(14). All of the tiers above the ultimate beneficial-owner customer in the indirect holding pyramid are, therefore, securities intermediaries.

the ultimate beneficial owner, and stepping up through the ranks of any other intermediaries through which the customer-level intermediary may have a clearing agency relationship.[43]

DTC is a limited purpose trust company owned by 132 "participant" shareholders.[44] DTC performs custodial holding services for more than 500 participant broker-dealers and banks that maintain securities accounts with the company.[45] It has as its primary mission the reduction of the transaction related costs of its participants.[46] It accomplishes this by facilitating the two key concepts in the indirect holding system: immobilization of certificates and netting of transactional book entries at each tier of the indirect holding pyramid.[47] DTC facilitates immobilization[48] by holding in its nominee name,

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[43] Schroeder notes that:

> Many small broker-dealers and financial intermediaries do not have accounts directly with DTC. Rather, they contract with larger national broker-dealers, banks or their affiliates to render so-called "backoffice" (*i.e.*, clearing and bookkeeping) services and to provide financing for the purchase of securities pending receipt of payment from the ultimate customers. The securities industry refers to those performing clearance functions as "clearing agents." Nevertheless, they are not "clearing corporations" for the technical purposes of Amended Article 8. They are only financial intermediaries. Consequently, there may be many tiers of financial intermediaries between Cede & Co., who has record ownership and legal title to the securities, and DTC which has physical custody of the certificates representing the securities, on the one hand, and the numerous individual investors who have beneficial and equitable ownership in the securities on the other.

Schroeder, *supra* note 3, at 327-28.

[44] THE DEPOSITORY TRUST COMPANY, 1995 ANNUAL REPORT 26 (1996). The participant owners include 61 broker-dealers, 65 banks, and six self-regulatory organizations. *Id.* The depository service today provided by DTC was originated by the New York Stock Exchange's Central Certificate Service, which eventually became known as DTC. *Id.* at 16.

[45] *Id.* at 20. "Essentially all of the trading in publicly held companies is executed through the broker-dealers who are participants in DTC." Rogers, *Policy Perspectives*, *supra* note 3, at 1444.

[46] THE DEPOSITORY TRUST COMPANY, 1995 ANNUAL REPORT 3 (1996).

[47] REVISED ARTICLE 8 OFFICIAL TEXT, *supra* note 2, at 40; *see also* 6 LOSS & SELIGMAN, *supra* note 10, at 2959-64; Ferrara & Alt, *supra* note 10, at 229-30; Rogers, *Policy Perspectives*, *supra* note 3, at 1442-43; Schroeder, *supra* note 3, at 324.

[48] *See* Rogers, *Policy Perspectives, supra* note 3, at 1443, ("[T]he key develop-

certificates representing the indirectly held securities owned by the customers of its intermediary participants (and the customers of the downstream intermediaries having direct or indirect clearing and settlement relationships with DTC's intermediary participants).[49] The securities are held, typically, in the form of "jumbo certificates"[50] representing hundreds of

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ment in the modern securities settlement system in the United States has been 'immobilization' rather than 'dematerialization.'").

[49] The shared characteristics of depository immobilization were described in a 1985 study by the SEC:

> Depository immobilization systems share several basic characteristics. First, certificates are safekept in depository vaults, and ownership interests are held in a fungible bulk. Thus, the transfer and record ownership mechanism can be viewed as "bifurcated." Second, transfers and pledges among depository participants can be effective when final entries are made on the depository's books, without registration on the issuer's books. Depositories keep a supply of certificates in different denominations to meet member withdrawal requests, and concentrate long-term positions in large denomination "jumbo certificates." Beneficial owners can obtain a certificate reflecting their ownership interests and can be recorded as owners on the issuer's books upon request from their bank or broker. In that case, the bank or broker instructs the depository to effect a withdrawal-by-transfer and to obtain a certificate issued in the name of the beneficial owner.

DIVISION OF MARKET REGULATION, SEC, PROGRESS AND PROSPECTS: DEPOSITORY IMMOBILIZATION OF SECURITIES AND USE OF BOOK-ENTRY SYSTEMS app. A (1985).

[50] DTC's process is described by Schroeder:

> DTC actually holds certificates in its vault. But, it will not hold a certificate for 100 shares of *XYZ* registered in my name, or even a certificate registered in my broker-dealer's name. Rather, it will hold one or two "jumbo certificates" representing all of the *XYZ* stock "held" on account of all of its account holders (and, indirectly, by their account holders' customers). DTC's records will not reflect my beneficial ownership. Rather, they will reflect the number of securities held on account of its participant companies (including my broker-dealer). Each participant will, in turn, only have records of the aggregate holdings of each of its account holders. Only my own broker-dealer will have any record of my ownership.

Schroeder, *supra* note 3, at 324-25. Securities represented by the "jumbo certificates" are not identified to, or segregated for any particular beneficial owner in the indirect system. In the words of section 8-313 of the 1978 version of Article 8, such securities represent a "fungible bulk." GUTTMAN, MODERN SECURITIES TRANSFERS, *supra* note 14, ¶ 8.01[1][b].

Immobilization is sometimes carried even a step beyond "jumbo certificates" held by common depositories. Depositories may leave certificates in the custody of the issuer's transfer agent. A transfer agent may maintain one certificate as a

thousands and sometimes millions of shares, in DTC's vaults at its main depository facility in Garden City, Long Island, or in other vaults of banks and clearing companies acting as DTC depository facilities pursuant to contractual arrangements.[51] The certificates remain "immobilized" in the vaults as long as DTC's overall position remains unchanged. Hundreds of thousands of trades may occur in a particular security at the beneficial ownership level, resulting in the constant need to adjust the amount of that security credited to the respective accounts of the various intermediaries in the chain leading up from the customers, but all of this can be accomplished by bookkeeping entries up and down the chain as long as the jumbo certificates at DTC continue to represent enough of the particular security to cover the overall indirect ownership of DTC participants and their downstream customers.[52] Cede & Co. remains the registered owner of the securities despite this constant fluidity of beneficial ownership and securities account levels. Thus, there is no need to indorse certificates, submit them to the issuer's transfer agent for cancellation, re-issue them in the name of the transferee, change the registered ownership on the securities records maintained on the issuer's behalf, or mail the new certificates out.[53]

DTC is not the only clearing depository. The Philadelphia Depository Trust Company (which holds securities primarily in its nominee names, "Philadelphia Depository Trust" or "PHILADEP") and the Pacific Securities Depository Trust (a wholly-owned subsidiary of the Pacific Stock Exchange) perform a similar immobilization function for participating intermediaries on a much smaller scale.[54] A substantial portion of

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"balance" certificate reflecting the depository's position and then issue and re-issue the balance certificate as necessary to reflect changes in the depository's position. J. Robert Brown, Jr., *The Shareholder Communication Rules and the Securities and Exchange Commission: An Exercise in Regulatory Utility or Futility?*, 13 J. CORP. L. 683, 723 n.190 (1988).

[51] THE DEPOSITORY TRUST COMPANY, 1994 ANNUAL REPORT 11 (1995). The vaults are protected by an extensive electronic security system and a uniformed guard force. *Id.* at 19.

[52] Rogers, *8 Ball, supra* note 3, at 46.

[53] *Id.*

[54] DIVISION OF MARKET REGULATION, SEC, PROGRESS AND PROSPECTS: DEPOSI-

indirectly held shares are also held in street or nominee name by broker-dealers, banks, or other intermediaries on behalf of beneficial-owner customers. However, DTC dominates the indirect holding system. As of December 31, 1995, DTC had custody of over ten trillion dollars in participant assets.[55] Among these assets were 74% of the shares of all companies listed on the New York Stock Exchange (NYSE), 58% of all shares traded in the Nasdaq Stock Market, and 50% of all shares traded on the American Stock Exchange (AMEX).[56] Somewhere between 60% and 80% of all the corporate equity traded in the U.S. public markets is held in the name Cede & Co.[57]

This immobilization of certificates in the indirect holding system, which plays such a crucial role in enabling clearing and settlement functions to keep up with the enormous trading volume in the U.S. public securities markets, has important ramifications which complicate achievement of other legal policy concerns. If you inspect a shareholder list maintained by practically any issuer with stock traded in the U.S. markets, the largest shareholder on the list will be Cede & Co., followed by other common depositories and securities intermediaries holding in street or nominee name.[58] The list will also reveal the names of all those shareholders who own their securities directly; and, a typical public company will have thousands of direct holders.[59] However, as discussed above,

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TORY IMMOBILIZATION OF SECURITIES AND USE OF BOOK-ENTRY SYSTEMS app. A (1985); *see also* BLOOMENTHAL, *supra* note 41, at 973.

[55] THE DEPOSITORY TRUST COMPANY, 1995 ANNUAL REPORT 20 (1996). At the close of 1995, DTC and its sister corporation, the National Securities Clearing Corporation (NSCC), worked together to absorb the depository and clearing business of Midwest Securities Trust Company (MSTC) and Midwest Clearing Corporation. MSTC's one hundred and thirty billion dollar inventory was moved to DTC by year end, and soon thereafter most of MSTC's members had become DTC participants. *Id.* at 5.

[56] *Id.* at 3.

[57] REVISED ARTICLE 8 OFFICIAL TEXT, *supra* note 2, at 40.

[58] Rogers, *8 Ball*, *supra* note 3, at 46. "Starting at the top, if we looked at shareholder records of IBM, or of any other corporation whose shares are publicly traded on the exchanges or in the over-the-counter market, we would find that one entity — Cede & Co. — is listed as the shareholder of record of somewhere in the range of 60 to 80 percent of the outstanding shares." *Id.*

[59] 6 LOSS & SELIGMAN, *supra* note 10, at 2964. While directly held shares

the vast majority of shares in the U.S. public securities markets are held indirectly; and, the most active institutional and individual investors most frequently hold indirectly.[60] As a result, perusing a shareholder list of a typical U.S. public company may tell a person very little about who owns and controls the company.[61] In addition, an issuer would not be able to communicate with the majority of its beneficial owners, for example, in connection with proxy solicitation, by relying solely on this list of registered holders.[62] U.S. federal securi-

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may constitute the minority of outstanding shares in the U.S. public markets, those shares are held by more holders than the indirectly held majority:

> To date the slowest progress [in advancing the immobilization of certificates] has concerned individual equity holdings. While these often are "immobilized" through street name arrangements, there is no universal requirement either of immobilization or of a book-entry system. The basic stumbling block here has been the requirement of several states that equity stock be represented by a certificate. Since there are far more individual than institutional investors, this suggests there is still a considerable way to go on this front.

6 LOSS & SELIGMAN, *supra* note 10, at 2964.

[60] Rogers, *8 Ball*, *supra* note 3, at 46. "Virtually all individual and institutional investors who are active traders hold their securities [through] broker-dealers or banks acting as securities custodians." Rogers, *8 Ball*, *supra* note 3, at 46.

[61] *See* Brown, *supra* note 50, at 691-92 ("With a large percentage of shares in street name or nominee accounts, a list of record owners often will prove unilluminating. Unaware of the number or identity of beneficial owners, issuers my find themselves owned by an anonymous mass of undisclosed shareholders.").

[62] State corporation statutes vest the power to vote shares in the record holder, *i.e.*, the street or nominee holder in the indirect holding system. *See, e.g.*, REVISED MODEL BUS. CORP. ACT §§ 1.40(22), 7.22(a), 7.23 (1984); *see also* BLOOMENTHAL, *supra* note 41, at 971; Brown, *supra* note 50, at 694-95. However, rules of the NYSE, AMEX, and NASD governing the brokerage community require broker-dealers to vote securities owned of record by them in street name, or on their behalf by nominees, only in accordance with instructions obtained from the beneficial owners of such securities; provided that broker-dealers who have sought such instructions and not obtained a response from the beneficial owners after a designated time period may go ahead and vote the securities on certain noncontroversial matters (the so-called "NYSE ten-day rule"). Rules 450-62, NYSE Manual (CCH) at A-131 to -148; Rule 577, *AMEX Constitution and Rules*, AMEX Manual (CCH) ¶ 9529, at 2720; Conduct Rule 2260, NASD Manual (CCH), at 4231. Brown explains that:

> Noncontroversial matters include uncontested elections for directors and approval of independent auditors. Controversial matters include "a merger, consolidation or any other matter which may affect substantially the rights or privileges of such stock." The ten-day rule enables uninstructed

ties laws deal with this problem in a number of ways. First, federal securities laws define ownership of securities, for purposes of nearly all relevant disclosure requirements, based on indicia of *beneficial* ownership rather than *record* ownership.[63] Thus, disclosure of significant share ownership in registration statements under the Securities Act of 1933 and in periodic reports and Williams Act filings (*e.g.*, Schedule 13D and Schedule 13G) under the Securities Exchange Act of 1934

> shares to be represented at a meeting, thereby facilitating the achievement of a quorum, but prevents brokers from influencing the outcome of controversial matters.

Brown, *supra* note 50, at 706-07. In order to vest the technical legal authority in the broker-dealers to vote securities held of record by DTC or another depository, an omnibus proxy is granted to the participating broker-dealers by DTC or the other depository. *See* BLOOMENTHAL, *supra* note 41, at 974.

[63] *See, e.g.*, Security Ownership of Certain Beneficial Owners and Management, 17 C.F.R. § 229.403 (1996) (Item 403 of Regulation S-K); Security Ownership of Certain Beneficial Owners and Management, 17 C.F.R. § 228.403 (1996) (Item 403 of Regulation S-B).

Under the SEC's integrated disclosure system, Item 403 of Regulation S-K and Item 403 of Regulation S-B dictate the disclosure requirements for the significant shareholder tables which must be set forth in registration statements under the Securities Act of 1933 and periodic reports and proxy statements under the Securities Exchange Act of 1934. The disclosure requirements are based on beneficial ownership, not record ownership, of shares. Beneficial ownership is defined in Item 403 of Regulation S-K by cross reference to Rule 13d-3 under the Securities Exchange Act of 1934 and is directly defined in Item 403 of Regulation S-B in terms identical to those in Rule 13d-3. *See* 17 C.F.R. § 229.403 (Instruction 2) (1996); 17 C.F.R. § 228.403 (1996) (Instruction 4) (1996). Rule 13d-3(a) under the Securities Exchange Act of 1934 provides that:

> [A] beneficial owner of a security includes any person who, directly or indirectly, through any contract, arrangement, understanding, relationship, or otherwise has or shares: (1) voting power which includes the power to vote, or to direct the voting of, such security; and/or (2) investment power which includes the power to dispose, or to direct the disposition of, such security.

Determination of Beneficial Owner, 17 C.F.R. § 240.13(d)-3(a) (1996).

Disclosures of five-percent ownership of equity securities of a public company on Schedules 13D and 13G under the Williams Act provisions of the Securities Exchange Act of 1934 are also based on beneficial ownership as defined in Rule 13d-3, not record ownership. 17 C.F.R. § 240.13d-1 (1996). Ten percent ownership status for purposes of the reporting and short-swing profit disgorgement requirements of section 16 of the Securities Exchange Act of 1934 also turns on beneficial ownership as defined in Rule 13d-3, not record ownership. 17 C.F.R. § 240.16a-1(a)(1) (1996).

turns on sole or shared power to vote or dispose of securities instead of record ownership.[64] In addition, transactions in equity securities are attributed to reporting persons under the reporting requirements of section 16 of the Securities Exchange Act of 1934 based on pecuniary benefit rather than record ownership.[65] Federal securities laws also impose on broker-dealers and banks an obligation to provide to a public issuer, upon request and payment of related expenses, a list of their beneficial-owner customers who indirectly own the issuer's securities and who do not object to such disclosure (so-called, "non-objecting beneficial owners" or "NOBOs").[66] Federal securities laws also impose on broker-dealers and banks an obligation to assist issuers, upon request and payment of related expenses, in distributing proxy materials and annual reports to beneficial owners in the indirect holding system.[67] Consequently, the immobilization of certificates comes at a price.

The second essential component of the indirect holding system is the netting of transactional book entries at each tier of the pyramid.[68] While the use of common depositories essentially eliminates the need for costly and time-consuming handling and delivery of certificates, an unworkable number of bookkeeping entries would have to be made in the records of the depositories if every securities trade executed between two participating intermediaries had to be run through the

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[64] *See supra* note 63.

[65] Under section 16 of the Securities Exchange Act of 1934, beneficial ownership is defined in terms of sole or shared power to vote or dispose of shares for purposes of determining ten percent shareholder status, *i.e.*, for purposes of determining whether a person is subject to section 16. 17 C.F.R. § 240.16a-1(a)(1) (1996). For purposes of attributing transactions to persons that are subject, however, beneficial ownership is defined in terms of "pecuniary interest." *Compare* 17 C.F.R. § 240.16a-1(a)(1) (1996), *with* 17 C.F.R. § 240.16a-1(a)(2) (1996).

[66] 17 C.F.R. §§ 240.14b-1(b) (1996). For a discussion of the operation of the NOBO rules, see Brown, *supra* note 50, at 754-58.

[67] 17 C.F.R. §§ 240.14a-13, .146-1, .146-2 (1996); 17 C.F.R. § 240.14a-2(b)(1)-(3) (1996). For a discussion of the operation of the proxy materials forwarding rules, see Brown, *supra* note 50, at 746-54.

[68] REVISED ARTICLE 8 OFFICIAL TEXT, *supra* note 2, at 40; *see also* Rogers, *Policy Perspectives, supra* note 3, at 1442.

books of the depository.[69] Instead, the indirect holding system nets all the transactions among depository participants that occur each trading day and, from this multi-lateral netting, derives one net receive or deliver obligation for each depository participant.[70] DTC is then instructed to make an adjustment corresponding to that net change in each respective participant's DTC account. Since 1976, this netting function has been performed by a separate corporation, National Securities Clearing Corporation (NSCC).[71] NSCC is the leading provider of centralized clearance, settlement, and related information services to over 1900 broker-dealers, banks, and mutual funds.[72] NSCC is owned jointly by the NYSE, AMEX and the National Association of Securities Dealers, Inc. (NASD).[73]

Today, virtually all publicly traded corporate equity securities, corporate debt securities, and municipal debt securities are eligible for deposit in the DTC system and netted clearing via NSCC.[74]

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[69] Rogers, *Policy Perspectives*, *supra* note 3, at 1442.

[70] *Id.* at 1442 ("Even further efficiency can be achieved by moving from a bilateral to a multilateral netting system through a centralized clearing facility, so that all trading activity of each participant on a given day is netted to a single deliver or receive position in each security with respect to all other participants.")

[71] *Id.* at 1442.

[72] NATIONAL SECURITIES CLEARING CORP., 1994 ANNUAL REPORT 1 (1995).

[73] *Id.* NSCC systems can handle a trading volume of over two billion shares per day. *Id.* at 4. NSCC provides clearance and settlement services to U.S. broker-dealers trading in overseas markets through the International Securities Clearing Corporation (ISCC), a wholly owned subsidiary of NSCC. *Id.* at 1. NSCC provides similar services for broker-dealers and banks trading in government securities through the Government Securities Clearing Corporation (GSCC), an affiliate. *Id.*

[74] THE DEPOSITORY TRUST COMPANY, 1995 ANNUAL REPORT 3 (1996). DTC has also implemented a similar depository settlement system for commercial paper, and an analogous book-entry system is operated by the Federal Reserve System for U.S. Treasury securities. REVISED ARTICLE 8 OFFICIAL TEXT, *supra* note 2, at 41. A depository settlement system was also developed by Participants Trust Company (PTC) for mortgage-backed securities. DTC, however, has assumed responsibility for a substantial portion of PTC's business. THE DEPOSITORY TRUST COMPANY, 1995 ANNUAL REPORT 9-10 (1996).

III. An Overview of Revised Article 8 and Related Sections

A. Basic Objectives, Principles, and Policies

The primary objective of Revised Article 8 is not to change the way the markets clear and settle securities trades or treat securities as collateral. Its primary objective is to better reflect the commercial reality of how the market currently operates[75] and to provide a structure with sufficient flexibility to continue to be an accurate reflection as the market develops.[76] By making Article 8 a better reflection of commercial reality, likelihood is increased that when problems arise or stresses occur in that commercial reality, Article 8 will provide relatively clear answers and a stable and reliable legal structure.[77] It was the lack of clear answers in the old version with respect to indirectly held securities that some cited as

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[75] *See* Rogers, *Policy Perspectives*, *supra* note 3, at 1441.

[76] *See* REVISED ARTICLE 8 OFFICIAL TEXT, *supra* note 2, at 41. Comments to the official text notes that:

> One of the objectives of the revision of Article 8 is to devise a structure of commercial law rules for investment securities that will be sufficiently flexible to respond to changes in practice over the next few decades. If it were possible to predict with confidence how the securities holding and trading system would develop, one could produce a statute designed specifically for the system envisioned. Recent experience, however, shows the danger of that approach.

Id. at 41.

[77] Rogers, *Policy Perspectives, supra* note 3, at 1436. Rogers explains:

> In recent years, a major topic of concern within the international financial community has been the control of systemic risk in the payment and securities systems. A part of that concern is directed toward assuring that the clearance and settlement system for securities trading operates in a safe and efficient fashion. In turn, one part of clearance and settlement reform is assessment and improvement of the legal foundation of the clearance and settlement system. It has increasingly been recognized that an antiquated system of commercial law rules for securities transfers could, in times of stress in the financial market, operate as a destabilizing factor, or at least impede efforts by responsible agencies to ensure the continued safe and efficient operation of the national system for the clearance and settlement of securities transactions. That is how a project to modernize a body of law as obscure as Article 8 of the Uniform Commercial Code got onto the agenda of law revision process.

Id. at 1436.

contributing to the October 1987 market break.[78]

As discussed earlier, Revised Article 8 does this primarily by dealing directly with the indirect holding system. Instead of engaging in a fictional analogy to possession and delivery by deeming that "all of the actors in the indirect holding system, at all levels in the pyramid, [have property interests] in the same discrete item of property — the security,"[79] Revised Article 8 simply admits that an indirect holder of a security owns a different type of property than a direct holder. Whereas a direct holder owns a package of rights running from the holder to the issuer, as embodied in the security itself, an indirect holder owns a package of rights running from the holder to the securities intermediary who maintains his securities account.[80] Revised Article 8 names this separate type of

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[78] *See* 1987 MARKET BREAK, *supra* note 3, *passim*.

[79] Rogers, *8 Ball, supra* note 3, at 46. Prior versions of Article 8 dealt with the indirect holding system only by analogy to the direct holding system:

> The keystone of the treatment of the indirect holding system in the prior version of Article 8 was the special provision on clearing corporations in Section 8-320. . . . Section 8-320 brought the depository system within Article 8 by definitional fiat. Subsection (a) of Section 8-320 (1962) stated that a transfer or pledge could be effected by entries on the books of a central depository, and subsection (b) stated that such an entry "has the effect of a delivery of a security in bearer form or duly indorsed in blank." In 1978, Section 8-320 was revised to conform it to the general substitution of the concept of "transfer" for "delivery," but the basic structure remained the same. Under the 1978 version of Article 8, the only book-entry transfers that qualified the transferee for bona fide purchaser rights were those made on the books of a clearing corporation. Thus, for practical purposes, the indirect holding system rules of the prior version of Article 8 required that the securities be held by a clearing corporation in accordance with the central depository rules of Section 8-320.
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> . . .
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> Section 8-313(1)(d) was the key provision in the 1978 version dealing with the indirect holding system at the level below securities depositories. It operated in essentially the same fashion as Section 8-320; that is, it stated that when a broker or bank holding securities in fungible bulk makes entries on its books identifying a quantity of the fungible bulk as belonging to the customer, that action is treated as a "transfer" — in the special Section 8-313 sense — of an interest in the security from the intermediary to the customer.

REVISED ARTICLE 8 OFFICIAL TEXT, *supra* note 2, at 54-55.

[80] Rogers, *Policy Perspectives, supra* note 3, at 1450-51; *see also infra* notes

property a "security entitlement" and, in new Part 5, defines the claims that make up this separate type of property and provides the rules that parallel the rules for direct holding in Parts 2, 3, and 4.[81]

Recognizing that a security entitlement is a different type of property and dealing with the differences directly and separately from direct holding has a number of important advantages all of which contribute to the most basic policy underlying revised Article 8: promoting greater certainty in securities transfers and hypothecation and thereby reducing the systemic risk in the securities markets.[82] A major advantage of the separate treatment is that Revised Article 8 makes it clear that an entitlement holder's claims are only against the securities intermediary who maintains the customer's account.[83]

174-225 and accompanying text.

[81] *See* Rogers, *Policy Perspectives*, *supra* note 3, at 1450-51.

[82] *Id.* at 1437. Discussing clearance and settlement reform, Rogers notes:

> Clearance and settlement reform is an aspect of the general problem of controlling "systemic risk" or, "the risk that the inability of one institution to meet its obligation when due will cause other institutions to be unable to meet their obligations when due." Put bluntly, the absence of mechanisms for control of systemic risk is why disturbances in the financial system used to be called "panics."

Id.

[83] *See* Mooney et al., *supra* note 3, at 1895. Mooney discusses Part 5 noting that:

> An important and overreaching principle embodied in Part 5 is that an entitlement holder, as a matter of private commercial law, can look only to the securities intermediary that it has chosen for the benefits of the financial assets that it claims. Part 5 invokes this intermediary-centric approach to risk by taking several complementary tacks. For example, it exculpates an entitlement holder from liabilities to an adverse claimant for conversion and the like if the entitlement holder acquires its security entitlement from the securities intermediary for value and without notice of an adverse claim. In this way, the entitlement holder's risks are centered on its own securities intermediary. The entitlement holder is not exposed to claims of those who would seek to trace their claims through a security entitlement maintained with another securities intermediary. A complementary rule prevents an entitlement holder from enforcing its property interest in financial assets against any purchaser from its securities intermediary unless the securities intermediary is in insolvency proceedings and acted wrongfully, and the purchaser failed to obtain "control" of the financial assets or the purchaser acted wrongfully.

This is an important clarification and one that greatly improves the fit of law to reality since, in the indirect holding system, only the securities intermediary who maintains the entitlement holder's securities account has any record of the customer.[84] Another advantage is that separate treatment permits Revised Article 8 to deal with post-settlement finality (*i.e.*, the negotiability rules which cut off adverse claims against a purchaser for value who takes without notice of such claims) in the indirect system in terms that fit commercial reality, thereby advancing one of the most fundamental purposes of Article 8.[85]

An additional advantage of recognizing that a security entitlement is a separate piece of property is that it permits clearer and more coherent choice-of-law rules.[86] Prior versions of Article 8 defined the interests of all tiers in the indirect holding system as a property interest in the same underlying security. Consequently, a key factor in determining the governing law for transactions in the direct system as well as the indirect system was the location of the security.[87] This operated satisfactorily in the direct holding context, but produced absurd results in the indirect system, especially with

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Id. at 1895.

[84] *See* Rogers, *Policy Perspectives*, *supra* note 3, at 1455. Rogers explains that:

> Revised Article 8 only gives legal recognition to the factual realities of the modern securities holding system. In a multi-tiered system of intermediaries, only a person's own immediate intermediary knows anything about that person's interest. Each intermediary knows only the identity of its own customers and the extent of their positions. An upper-tier intermediary's customer may be someone else's intermediary, but the upper-tier intermediary has no way of knowing anything about its customer's customer's. Accordingly, the realities of the marketplace dictate that an intermediary can only be held responsible to its own customers.

Id. at 1455.

[85] For a detailed discussion of post-settlement finality and the evolution of the Article 8 terms dealing with adverse claim cut-off in the direct and indirect holding systems, see Rogers, *Policy Perspectives*, *supra* note 3, at 1460-73 and *infra* notes 226-34 and accompanying text.

[86] Rogers, *Policy Perspectives*, *supra* note 3, at 1457-60.

[87] *Id.* 1457-58.

respect to secured lending transactions.[88] Under the choice-of-law rules in Revised Article 8,[89] certificate location remains a key factor for transactions involving certificated securities that are directly held,[90] but the key factor in the indirect system is the jurisdiction of the securities intermediary whose relationship with the holder constitutes the security entitlement.[91]

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[88] *Id.* at 1457-58.

[89] The choice-of-law provisions of Revised Article 8 are contained in section 8-110, dealing with questions of validity of the security, obligations of the issuer or securities intermediary and acquisition and negotiability rules, and section 9-103, dealing with questions of perfection and priority. *See* U.C.C. §§ 8-110, 9-103 (1996).

[90] *See* U.C.C. §§ 8-110(a), 8-110(c), 9-103(6)(b) (1996). Choice of law in the direct holding system is determined by location of the certificate or by local law of the issuer's jurisdiction, depending on the context and whether a certificated or uncertificated security is involved. "Issuer's jurisdiction" is defined as the "jurisdiction under which the issuer of the security is organized or, if permitted by the law of that jurisdiction, the law of another jurisdiction specified by the issuer." U.C.C. § 8-110(d) (1996). The only exception to choice-of-law determination according to location of certificate or issuer's jurisdiction is that questions of perfection by filing or automatic perfection of a security interest in investment property granted by a broker, securities intermediary or commodity intermediary are governed by the local law of the jurisdiction in which the debtor is located under section 9-103(f). *Id.* § 9-103(6)(f).

[91] *Id.* §§ 8-110(b), 9-103((6)d). Under section 8-110(e), a securities intermediary's jurisdiction is determined as follows:

> (1) If an agreement between the securities intermediary and its entitlement holder specifies that it is governed by the law of a particular jurisdiction, that jurisdiction is the securities intermediary's jurisdiction.
> (2) If an agreement between the securities intermediary and its entitlement holder does not specify the governing law as provided in paragraph (1), but expressly specifies that the securities account is maintained at an office in a particular jurisdiction, that jurisdiction is the securities intermediary's jurisdiction.
> (3) If an agreement between the securities intermediary and its entitlement holder does not specify a jurisdiction as provided in paragraph (1) or (2), the securities intermediary's jurisdiction is the jurisdiction in which is located the office identified in an account statement as the office serving the entitlement holder's account.
> (4) If an agreement between the securities intermediary and its entitlement holder does not specify a jurisdiction as provided in paragraph (1) or (2) and an account statement does not identify an office serving the entitlement holder's account as provided in paragraph (3), the securities intermediary's jurisdiction is the jurisdiction in which is located the chief executive office of the securities intermediary.

Id. § 8-110(e). The securities intermediary's jurisdiction is not, in any event, deter-

Although Revised Article 8 deals directly and separately with the indirect holding system (and such system dominates the U.S. public markets), Article 8 does so in a manner that does not favor the indirect system over the direct holding system. Revised Article 8 is drafted based on a neutrality principle which is intended to permit the market to find its own way.[92]

B. Key Definitions and Scope

Part 1 of Revised Article 8 defines key terms and concepts that are essential to understanding the scope of Revised Article 8 and its constituent parts, including the revisions to Article 9 dealing with security interests.

1. Security

The definition of "security" in section 8-102(a)(15) is the core jurisdictional definition of Revised Article 8. It essentially tracks the definition of security in the 1978 version.[93] The definition includes:

> an obligation of an issuer or a share, participation, or other

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mined by the physical location of certificates, the jurisdiction of organization of the issuer or the location or facilities for data processing or other record keeping concerning the securities account. *Id.* § 8-110(f).

The only exception to the determination of choice of law according to the securities intermediary's jurisdiction is that questions of perfection by filing or automatic perfection of a security interest in investment property granted by a broker, securities intermediary or commodity intermediary are governed by the local law of the jurisdiction in which the debtor is located under section 9-103(6)(f). *See id.* § 9-103(6)(f).

[92] REVISED ARTICLE 8 OFFICIAL TEXT, *supra* note 2, at 42. Comments to the Official Text note:

> Revised Article 8 takes a neutral position on the evolution of securities holding practices. The revision was based on the assumption that the path of development will be determined by market and regulatory forces and that the Article 8 rules should not seek to influence that development in any specific direction. . . . [A]n effort has been made to identify and eliminate any Article 8 rules that might act as impediments to any of the foreseeable paths of development.

Id. at 42.

[93] *Id.* at 44.

> interest in an issuer or in property or an enterprise of an issuer:
> (i) which is represented by a security certificate in bearer or registered form, or the transfer of which may be registered upon books maintained for that purpose by or on behalf of the issuer;
> (ii)which is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations; and
> (iii) which:
>
> (A) is, or is of a type, dealt in or traded on securities exchanges or securities markets; or
>
> (B) is a medium for investment and by its terms expressly provides that it is a security governed by this Article.[94]

The three requirements of the definition (transferability, divisibility and the functional requirement of being a type that is traded or opting in)[95] are explained and amplified in section 8-103.[96] Corporate stocks and bonds clearly fall within the definition, whether or not they are publicly traded (since they are all *types* of securities that are publicly traded).[97] Treasury securities, municipal bonds, and all types of investment company securities are also clearly covered.[98] Partnership interests and limited liability company interests are not covered unless they are in fact traded on a securities exchange or in a securities

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[94] U.C.C. § 8-102(a)(15) (1996).

[95] *See id.* § 8-102 cmt. 15.

[96] *Id.* § 8-103 cmt. 1. The comment to section 8-105 notes:

> The Section 8-102 definitions are worded in general terms, because they must be sufficiently comprehensive and flexible to cover the wide variety of investment products that now exist or may develop. The rules in this section are intended to foreclose interpretive issues concerning the application of the general definitions to several specific investment products.

Id. Extensive additional discussion of the scope of coverage is contained in the REVISED ARTICLE 8 OFFICIAL TEXT, *supra* note 2, at 46-53.

[97] U.C.C. § 8-103 cmt. 2 (1996); REVISED ARTICLE 8 OFFICIAL TEXT, *supra* note 2, at 46-47, 49-50.

[98] U.C.C. § 8-103 cmt. 3 (1996); REVISED ARTICLE 8 OFFICIAL TEXT, *supra* note 2, at 47-48, 49-50.

market.[99] Likewise, traded stock options,[100] commodity investments,[101] and most money market instruments are not covered.[102]

While the definition of security has not significantly changed in Revised Article 8, the function of the definition is significantly different: it no longer determines the coverage of all of Article 8.[103] The direct holding system rules of Parts 2, 3, and 4 of Revised Article 8 apply only to securities.[104] The indirect holding system rules of Part 5, however, apply to any security entitlement, including any "financial asset" held indi-

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[99] REVISED ARTICLE 8 OFFICIAL TEXT, *supra* note 2, at 50. Such types of investment are not of a type normally traded in public markets. Partnership or LLC interests could, however, be brought within the functional requirement of the "security" definition by "opt-in." REVISED ARTICLE 8 OFFICIAL TEXT, *supra* note 2, at 50. Although not securities, such interests could be "financial assets" held in a "securities account" and, consequently, give rise to a "security entitlement" subject to the indirect holding system rules in Part 5 of Revised Article 8. REVISED ARTICLE 8 OFFICIAL TEXT, *supra* note 2, at 50.

[100] U.C.C. § 8-103(e) (1996). Although not securities, traded stock options could be "financial assets" held in a "securities account" and, consequently, give rise to a "security entitlement" subject to the indirect holding system rules in Part 5 of Revised Article 8. *Id.*; *see also* REVISED ARTICLE 8 OFFICIAL TEXT, *supra* note 2, at 51-52.

[101] U.C.C. § 8-103(f) (1996). A commodity contract is neither a "security" nor a "financial asset." Consequently it is not subject to Parts 2, 3, or 4 of Revised Article 8; and, the relationship between a customer and a commodities futures commission merchant who maintains an account for the customer is not a security entitlement subject to Part 5 of Article 8. REVISED ARTICLE 8 OFFICIAL TEXT, *supra* note 2, at 52. However, a commodity contract and a commodity account are included in the definition of "investment property" under revised section 9-115 and are therefore subject to the new security interest provisions also applicable to securities section and security entitlements. *Id.*; *see also infra* notes 128-32 and accompanying text.

[102] REVISED ARTICLE 8 OFFICIAL TEXT, *supra* note 2, at 50. Even if particular money market instruments (*e.g.*, commercial paper, bankers' acceptances, or certificates of deposit) are not securities, they could be "financial assets" held in a "securities account" and, consequently, give rise to a "security entitlement" subject to the indirect holding system rules in Part 5 of Revised Article 8. *Id.* To the extent particular money market instruments do constitute securities under the section 8-102(a)(15) definition, they are governed by Article 8 even though they may also constitute "negotiable instruments" for purposes of Article 3. U.C.C. § 8-103(d) (1996).

[103] *Id.* at 44.

[104] *Id.*

rectly through a securities intermediary.[105] Securities are a subset of financial assets.[106] Moreover, the revised provisions of Article 9 govern security interests in any "investment property."[107] Securities and security entitlements are both subsets of investment property.[108]

2. *Security entitlement; entitlement holder; securities account*

The term coined by Revised Article 8 to deal directly with the indirect holding system, "security entitlement," is defined in section 8-102(a)(17) as the rights and property interest of a person who holds a security or other financial asset through a securities intermediary.[109] The person identified in the records of the securities intermediary as the person having a security entitlement against the intermediary is defined as the "entitlement holder."[110] The core consensual arrangement between the securities intermediary and the entitlement holder that creates the security entitlement is defined in section 8-501(a) as a "securities account" — "an account to which a financial asset is or may be credited in accordance with an agreement under which the person maintaining the account undertakes to treat the person for whom the account is maintained as entitled to exercise the rights that comprise the financial asset."[111] This undertaking by the securities intermediary to treat the other person as entitled to the rights of the

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[105] *Id.*; *see* U.C.C. § 8-102(a)(17) (1996).

[106] *See* U.C.C. § 8-102(a)(9) (1996); *see also infra* notes 123-27 and accompanying text.

[107] *See* U.C.C. § 9-115 (1996); *see also infra* notes 128-32 and accompanying text.

[108] *See* U.C.C. § 9-115(f) (1996); *see also infra* notes 128-32 and accompanying text.

[109] U.C.C. § 8-102(a)(17) (1996). For the Revised Article 8 definition of securities intermediary, see note 42.

[110] U.C.C. § 8-102(a)(7) (1996). An entitlement holder "is a person identified in the records of a securities intermediary as the person having a security entitlement against the securities intermediary If a person acquires a security entitlement by virtue of section 8-501(b)(2) or (3), that person is the entitlement holder." *Id.*

[111] *Id.* § 8-501(a).

financial asset gives rise to the security entitlement and makes the rules of Part 5 apply.[112] This undertaking also differentiates a security entitlement from other types of arrangements that may exist between a registered holder of a security or other financial asset and another person possessing some beneficial interest therein.[113]

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[112] The comment to section 8-501 reads:

> Whether an arrangement between a firm and another person concerning a security or other financial asset is a "securities account" under this Article depends on whether the firm has undertaken to treat the other person as entitled to exercise the rights that comprise the security or other financial asset. . . .
>
> The effect of concluding that an arrangement is a securities account is that the rules of Part 5 apply. Accordingly, the definition of "securities account" must be interpreted in light of the substantive provisions in Part 5, which describe the core features of the type of relationship for which the commercial law rules of Revised Article 8 concerning security entitlements were designed.

Id. § 8-501 cmt. 1.

[113] Comment one to section 8-501 notes:

> There are many arrangements between institutions and other persons concerning securities or other financial assets which do not fall within the definition of "securities account" because the institutions have not undertaken to treat the other persons as entitled to exercise the ordinary rights of an entitlement holder specified in the Part 5 rules. For example, the term securities account does not cover the relationship between a bank and its depositors or the relationship between a trustee and the beneficiary of an ordinary trust, because those are not relationships in which the holder of a financial asset has undertaken to treat the other as entitled to exercise the rights that comprise the financial asset in the fashion contemplated by the Part 5 rules.

Id. For further discussion of relationships not constituting securities accounts, see REVISED ARTICLE 8 OFFICIAL TEXT, *supra* note 2, at 47-53.

For obvious reasons, a security entitlement does not arise when financial assets are registered directly in the name of a customer but physically held in safekeeping by a securities intermediary. *See* U.C.C. § 8-501(d) (1996). Such financial assets are treated as being held directly by the customer and, if they constitute securities, are subject to Parts 2, 3, and 4 of Revised Article 8. U.C.C. § 8-501(d) (1996).

Section 8-501(e) also specifies that a security entitlement does not arise upon issuance of a security that represents an interest in assets owned by the issuer (as opposed to carried in a securities account). *Id.* § 8-501(e). For example, issuance of American depository receipts or asset-backed securities does not create a securities account relationship between the issuer and the issuee and therefore a security entitlement. *Id.* § 8-501 cmt. 5. The issuer does not in such cases undertake to treat the issuee as entitled to exercise the rights that comprise the securities un-

In the indirect holding system pyramid, each tier is an entitlement holder with a securities account maintained by the intermediary in the tier above it.[114] DTC maintains securities accounts for its participant broker-dealers and banks, and the participant broker-dealers and banks maintain securities accounts for their various customer-investors.[115] Each tier has a security entitlement against the intermediary above it; each such security entitlement is a different piece of property; and each tier's rights and property interest are defined and governed by Part 5 of Revised Article 8.[116] The securities intermediary at the top of the pyramid, however, is the registered owner of the financial asset.[117] Its rights and property interest against the issuer are defined by the security or other financial asset itself; Parts 2, 3, and 4 of Revised Article 8 govern its transactions.[118]

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derlying the ADRs or the mortgages or other assets underlying the asset-backed securities. *Id.*

[114] REVISED ARTICLE 8 OFFICIAL TEXT, *supra* note 2, at 47. Discussing Part 5, commentators note:

> The relationship between the clearing corporation and its participants is governed by the indirect holding system rules of Part 5. At that level, the clearing corporation is the securities intermediary and the participant is the entitlement holder. If the participant is itself a securities intermediary, such as a broker holding for its customers or a bank acting as a securities custodian, the Part 5 rules apply to its relationship to its own customers. At that level the broker or bank custodian is the securities intermediary and the customer is the entitlement holder. Note that the broker or bank custodian is both an entitlement holder and a securities intermediary — but is so with respect to different security entitlements. For purposes of Article 8 analysis, the customer's security entitlement against the broker or bank custodian is a different item of property from the security entitlement of the broker or bank custodian against the clearing corporation.

Id.

[115] *Id.*

[116] *Id.*

[117] *Id.*

[118] *Id.* Commentators note:

> Thus the rules of Parts 2, 3 and 4 of Revised Article 8 apply to the relationship between the issuer and the clearing corporation. If, as is typically the case today, the securities are still represented by certificates, the clearing corporation will be the holder of the security certificate or certificates representing its total holdings. So far as Article 8 is

A security entitlement is both a bundle of personal rights and an interest in the property held by the securities intermediary.[119] It is not, however, a specific property interest in any particular, identifiable, financial asset held by the securities intermediary or the depository holding on its behalf.[120]

> concerned, the relationship between the issuer and the clearing corporation is no different from the relationship between the issuer and any other registered owner.

Id.

[119] U.C.C. § 8-102 cmt. 17 (1996). The property interest of the entitlement holder is described in section 8-503(b):

> An entitlement holder's property interest with respect to a particular financial asset under subsection (a) is a pro rata property interest in all interests in that financial asset held by the securities intermediary, without regard to the time the entitlement holder acquired the security entitlement or the time the securities intermediary acquired the interest in that financial asset.

Id. § 8-503(b). Entitlement holders receive:

> a property interest in underlying financial assets. Property law doctrine thus offers a convenient means of ensuring that financial assets necessary to satisfy claims of entitlement holders are not subjected to the claims of a securities intermediary's general creditors because the financial assets belong to the entitlement holders, not the securities intermediary. But, for the most part, property law doctrine plays a very minor role in determining the status of entitlement holders vis-a-vis competing claims in the indirect holding system.

Mooney et al., *supra* note 3, at 1894-95. "Thus, a security entitlement is not merely an *in personam* claim against the intermediary, but a property interest consisting of a pro-rata claim to the fungible pool of underlying securities held by the intermediary." Rogers, *supra* note 3, at 692.

[120] The property right of each entitlement holder with respect to a financial asset held by a through an intermediary is a pro rata share of an interest in common with all entitlement holders who have entitlements to such financial asset, not a claim to an identifiable, traceable financial asset. It is a pro rata property interest in the fungible pool of financial assets so held. Although the term "fungible bulk" used in the 1978 version is not used in Revised Article 8 (based, perhaps, on lack of euphony), the concept is the same:

> Although this section recognizes that the entitlement holders of a securities intermediary have a property interest in the financial assets held by the intermediary, the incidents of this property interest are established by the rules of Article 8, not by common law property concepts. . . . A person's claim of ownership of a certificated security is a right to a specific identifiable physical object, and that right can be asserted against any person who ends up in possession of that physical certificate, unless cut off by the rules protecting purchasers for value without

The definition in section 8-102(a)(17) is really just a cross-reference to Part 5.[121] The rights and property interest of the entitlement holder described in Part 5 make up the real definition of security entitlement.[122]

3. *Financial asset*

"Financial asset" is the term used to describe the types of property to which the indirect holding system rules of Part 5 apply when the property is held through a securities intermediary.[123] As such, the term defines, in conjunction with the definition of securities account, the scope of Part 5.[124] Financial asset is defined in section 8-102(a)(9) to include a security as well as:

> an obligation of a person or a share, participation, or other interest in a person or in property or an enterprise of a person, which is, or is of a type, dealt in or traded on financial

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> notice. Those concepts do not work for the indirect holding system. A security entitlement is not a claim to a specific identifiable thing; it is a package of rights and interests that a person has against the person's securities intermediary and the property held by the intermediary. The idea that discrete objects might be traced through the hands of different persons has no place in the Revised Article 8 rules for the indirect holding system.

U.C.C. § 8-503 cmt. 2 (1996).

[121] *Id.* § 8-102 cmt. 17.

[122] *Id.*

[123] *Id.* § 8-102 cmt. 9.

[124] *Id.* The definition of financial asset is only significant under Revised Article 8 in conjunction with the definition of securities account:

> The fact that something does or could fall within the definition of financial asset does not, without more, trigger Article 8 coverage. The indirect holding system rules of Revised Article 8 apply only if the financial asset is in fact held in a securities account, so that the interest of the person who holds the financial asset through the securities account is a security entitlement. Thus, questions of the scope of the indirect holding system rules cannot be framed as "Is such-and-such a "financial asset" under Article 8?" Rather, one must analyze whether the relationship between an institution and a person on whose behalf the institution holds an asset falls within the scope of the term securities account as defined in section 8-501. That question turns in large measure on whether it makes sense to apply the Part 5 rules to the relationship.

Id. § 8-105 cmt. 9.

> markets, or which is recognized in any area in which it is issued or dealt in as a medium for investment."[125]

The definition is open-ended and functional, like the definition of security, in order to provide flexibility for market developments. Using a different definition to define the scope of the direct holding and indirect holding system rules not only accommodates current differences, but also provides freedom for market developments in different directions, thus promoting the neutrality principle of Revised Article 8.[126] Examples of financial assets that are not also securities are money market instruments (*e.g.*, commercial paper, bankers' acceptances, and certificates of deposit), untraded partnership or limited liability company interests, and traded stock options.[127]

4. Investment property

Defined in section 9-115(1)(f), "investment property" circumscribes the coverage of the new Article 9 provisions for secured transactions.[128] Investment property includes securities, security entitlements, and securities accounts, the realm of Revised Article 8.[129] Investment property also includes,

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[125] U.C.C. § 8-102(a)(9) (1996). The definition goes on to include an additional opt-in provision, comparable to that in the definition of security, sweeping in:

> any property that is held by a securities intermediary for another person in a securities account if the securities intermediary has expressly agreed with the other person that the property is to be treated as a financial asset under this Article.

Id. § 8-102(a)(9)(iii).

[126] *Id.* § 8-102 cmt. 9. "Having separate definitions of security and financial asset makes it possible to separate the question of the proper scope of the traditional Article 8 rules from the question of the proper scope of the new indirect holding system rules." *Id.*

[127] *See* REVISED ARTICLE 8 OFFICIAL TEXT, *supra* note 2, at 50, 51-52. While some money market instruments are not securities, others may be classified as such. *Id.* at 51.

[128] U.C.C. § 9-115 cmt. 1 (1996).

[129] *Id.* § 9-115(1)(f)(i)-(iii). Inclusion of securities accounts themselves is a drafting facilitator in revised Article 9 to permit easier reference when security interests are granted with respect to a debtor's entire account instead of a specific security entitlement. *Id.* § 9-115 cmt. 4. "Referring to the collateral as the securities account is a simple way of describing all of the security entitlements carried in the account." *Id.*

however, commodity contracts and commodity accounts, investment categories that are not covered by Article 8.[130] Consequently, commodity contracts are not securities governed by Parts 2, 3, or 4 of Revised Article 8, and interests in accounts maintained by a futures commission merchant on behalf of a customer are not security entitlements governed by Part 5 of Revised Article 8.[131] However, security interests in commodity contracts held directly or indirectly through an intermediary are subject to the same rules as security interests in securities and security entitlements.[132]

C. Parts 2, 3, and 4: Major Revisions to the Provisions on Directly Held Securities

The primary objective of Revised Article 8 was to deal directly with the indirect holding system, not to revamp the provisions dealing with the direct holding system. Parts 2, 3, and 4 of Revised Article 8, therefore, retain the basic conceptual structure and rules of the prior version with respect to certificated and uncertificated securities which are held directly[133]. As before, Part 2 focuses on obligations of the issuer in the direct holding system.[134] Part 3 deals with transfer of securities directly held and related principles of negotiability.[135] Part 4 focuses on registration of transfer by the issuer or its

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[130] *Id.* § 9-115(1)(f)(iv)-(v) (1996). "Commodity contract" is defined as:

> a commodity futures contract, an option on a commodity futures contract, a commodity option, or other contract that, in each case, is: (i) traded on or subject to the rules of a board of trade that has been designated as a contract market for such a contract pursuant to the federal commodities laws; or (ii) traded on a foreign commodity board of trade, exchange, or market, and is carried on the books of a commodity intermediary for a commodity customer.

Id. § 9-115(1)(b). "Commodity account" is defined as "an account maintained by a commodity intermediary in which a commodity contract is carried for a commodity customer." *Id.* § 9-115(1)(a).

[131] REVISED ARTICLE 8 OFFICIAL TEXT, *supra* note 2, at 45.

[132] *Id.*

[133] *Id.* at 42. The revised version altered only terminology and organization. *Id.*

[134] *Id.* at 45. Part 2 is substantially unchanged from the 1978 version. *Id.*

[135] *Id.* Part 3 aims to protect investment securities against adverse claims. *Id.*

transfer agent.[136]

Although the basic conceptual structure is intact, changes were made in Parts 2, 3, and 4.[137] Since new Part 5 now deals with the indirect holding system, the provisions in the 1978 version which attempted to deal with indirect holdings could be eliminated from Revised Article 8, resulting in significant simplification of Part 3.[138] Additional streamlining of Parts 2, 3, and 4 was achieved by eliminating where possible the repetitious parallelism of rules for certificated and uncertificated securities which characterized the 1978 version.[139] Revised Article 8 states direct holding rules wherever possible in terms of "securities" (*i.e.*, the underlying intangible interest or obligation) generally and states rules in terms of "certificated securities" or "uncertificated securities" (*i.e.*, the form of evidence of the security) only where the distinction in form is essential to the rule. This makes much of the apparent difference between the rules for each form of embodiment in the 1978 version disappear and simplifies the direct holding rules in Revised Article 8.

In addition to these drafting and organizational improvements. Article 8 also made a number of substantive alterations

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[136] REVISED ARTICLE 8 OFFICIAL TEXT, *supra* note 2, at 45.

[137] *Id.*

[138] *Id.* The principal provisions of the 1978 version dealing with holdings through securities intermediaries were contained in sections 8-313 and 8-320. U.C.C. §§ 8-313, 8-320 (1978) (amended in 1996); *see also* REVISED ARTICLE 8 OFFICIAL TEXT, *supra* note 2, at 45.

[139] *See* REVISED ARTICLE 8 OFFICIAL TEXT, *supra* note 2, at 42-43. Commentators note:

> The 1978 version added provisions on uncertificated securities parallel to the provisions of the original version of Article 8 dealing with securities represented by certificates. Thus, virtually every section had one set of rules on "certificated securities" and another on "uncertificated securities." The constant juxtaposition of "certificated securities" and "uncertificated securities" has probably led readers to overemphasize the differences. . . . In Revised Article 8, the difference between certificated and uncertificated is treated not as an inherent attribute of the security but as a difference in the means by which ownership is evidenced. The terms "certificated" and "uncertificated" security are used in those sections where it is important to distinguish between these two means of evidencing ownership.

Id.

in the direct holding rules, including:

1. Elimination of transaction statements

The uncertificated securities rules put in place in the 1978 version contemplated a system of direct registration of securities without paper reification. The provisions added in 1978 did not, however, eliminate all requirements of paper evidence of transactions. Section 8-408 of the 1978 version required issuers of uncertificated securities to send paper "transaction statements" upon registration of transfers and pledges to the former and the new registered owners and the former and the new registered pledgees.[140] Section 8-408 required such issuers to send additional transaction statements to registered owners and pledgees periodically and upon reasonable written request.[141] These transaction statements were required to contain specified information, but were also to provide conspicuously that they were merely a record of the rights of the addressees at the time they were sent and that they conferred no rights on the addressees themselves.[142] Finally, the legend was to read that the statements were neither negotiable instruments nor securities.[143]

Revised Article 8 eliminates this cumbersome requirement entirely, leaving the record keeping and reporting obligations of issuers of uncertificated securities to specification by agreement or by other bodies of law.[144] This not only eliminates the need

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[140] U.C.C. § 8-408 (1978) (amended in 1996).

[141] *Id.* § 8-408(6)-(7). The issuer was permitted to charge fees for such requested transaction statements if such statements were otherwise provided at least quarterly. *Id.* § 8-408(8).

[142] *Id.* § 8-408(9).

[143] *Id.*

[144] REVISED ARTICLE 8 OFFICIAL TEXT, *supra* note 2, at 57. Since the transaction statement requirement would not be triggered by transactions in the indirect holding system and since the 1978 version imposed no transaction statement requirement on securities intermediaries, elimination of the whole transaction statement requirement puts uncertificated securities in the direct system and the indirect system on an equal footing:

> The detailed specification of reporting requirements for issuers of uncertificated securities was quite different from the treatment of securities intermediaries. Though the prior version of Article 8 did require

for old section 8-408, but also permits the simplification and streamlining of provisions in Part 2 which had contained further transaction statement requirements and had dealt with wrongful information and forgery in such statements.[145] Since uncertificated securities have not taken root to any substantial extent in the U.S. markets, eliminating transaction statements does not disrupt dominant practices and, in fact, removes a possible impediment to wider adoption of the uncertificated approach.[146]

2. Elimination of registered pledges

Revised Article 8 also eliminated the provisions of the 1978 version relating to "registered pledges."[147] Under the 1978 version, issuers of uncertificated securities were required to offer a means by which a pledgee could register its security interest with the issuer, and thereby perfect it, while the debtor remained the registered owner of the securities (for purposes of voting and dividends).[148] The registered pledge provided a perfection mechanism for uncertificated securities that paralleled the possessory pledge for certificated securities.[149] However, the mechanism had many critics.[150]

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non-clearing corporation securities intermediaries to send confirmations of transfers — a requirement deleted in Revised Article 8 — it did not regulate their content or format. Article 8 has never imposed periodic reporting requirements on securities intermediaries. Thus, reporting requirements for the indirect holding system were left to agreements and regulatory authorities, while reporting requirements for a book-entry direct holding system were imposed by statute.

Id.

[145] *See, e.g.,* U.C.C. § 8-202 (1978) (1996) (requiring additional content); *id.* § 8-204 (requiring inclusion of restrictions); *id.* § 8-205 (addressing unauthorized signature); *id.* § 8-206 (addressing alteration); *id.* § 8-208 (addressing authentication).

[146] Revised Article 8 Official Test, *supra* note 2, at 57.

[147] *Id.*

[148] U.C.C. §§ 8-108, 8-207 (1978).

[149] *Id.* § 8-108 cmt. "The rights of the registered pledgee. . . are intended to resemble, as closely as possible, the rights of the pledgee of a certificated security who retains possession of the pledged security without reregistration." *Id.*

[150] *See* REVISED ARTICLE 8 OFFICIAL TEXT, *supra* note 2, at 57. Professor Schroeder, for example, called registered pledges burdensome and conceptually incoherent. Schroeder, *supra* note 3, at 387.

Massachusetts, home state for many mutual funds (issuing uncertificated

Under Revised Article 8 and the related revisions of Article 9, a security interest in uncertificated securities may be perfected by a number of means which permit the debtor to remain the registered owner.[151] A secured party may perfect by filing.[152] A secured party may also enter into agreements with the debtor and the issuer giving the secured party "control," and thereby both perfect its security interest and obtain priority the same as under the old registered pledge mechanism.[153] The revisions thus eliminate the record-keeping burden of the registered pledge as a requirement, but offer debtors, secured parties, and issuers an equivalent means of perfection and priority by agreement if that is the direction of evolution in the market.[154]

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securities), adopted a non-uniform version of the registered pledge provisions which gave issuers the option of issuing a paper certificate to an owner instead of complying with a request for a registered pledge. REVISED ARTICLE 8 OFFICIAL TEXT, *supra* note 2, at 57.

[151] For an overview of the new provisions governing perfection of security interests in revised Article 9, see *infra* notes 278-87 and accompanying text.

[152] U.C.C. § 9-115(4)(b) (1996); *see infra* notes 279-80 and accompanying text.

[153] U.C.C. §§ 8-106, 9-115(4)-(5) (1996); *see infra* notes 250-58 and accompanying text.

[154] *See* REVISED ARTICLE 8 OFFICIAL TEXT, *supra* note 2, at 58. Commentators note:

> Under the rules of Revised Articles 8 and 9, the registered pledge issue can easily be left to resolution by the market. The concept of control is defined in such fashion that if an issuer or securities intermediary wishes to offer a service akin to the registered pledge device it can do so. The issuer or securities intermediary would offer to enter into agreements with the debtor and secured party under which it would hold the securities for the account of the debtor, but subject to instructions from the secured party. The secured party would thereby obtain control assuring perfection and priority of its lien.
>
> Even if such arrangements are not offered by issuers, persons who hold uncertificated securities will have several options for using them as collateral . . . . Under the new rules, filing is a permissible method of perfection, for debtors other than securities firms. A secured party who relies on filing is, of course, exposed to the risk that the debtor will double finance and grant a later secured lender a security interest under circumstances that give that lender control and hence priority. If the lender is unwilling to run that risk, the debtor can transfer the securities outright to the lender on the books of the issuer, though between the parties the debtor would be the owner and the lender only a secured party.

3. Protected purchasers: eliminating the "good faith" element

The basic negotiability rule in section 8-302 of the prior versions of Article 8 provided that a "bona fide purchaser," a purchaser for value in good faith and without notice of any adverse claim,[155] acquires securities free of any adverse claim.[156] Revised Article 8 deletes the reference to "good faith" and changes the term "bona fide purchaser" to "protected purchaser."[157] Instead of dealing with the problem of a purchaser's willful blindness to suspicious circumstances evidencing adverse claims through a vague and indirect requirement of good faith, Revised Article 8 addresses the problem more precisely and more squarely in the new definition of "notice of adverse claim" in section 8-105.[158] A purchaser has

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REVISED ARTICLE 8 OFFICIAL TEXT, *supra* note 2, at 58; *see also* Schroeder, supra note 3, at 388 ("Time will tell whether it will ever become common for public companies to agree to recognize transfer orders from persons other than registered owners. The historical experience with respect to 'registered pledges' suggests that it won't.").

[155] U.C.C. § 8-302(1) (1978). Section 8-302 provided:

> A "bona fide purchaser" is a purchaser for value in good faith and without notice of any adverse claim: (a) who takes delivery of a certificated security in bearer form or in registered form, issued or indorsed to him or in blank; (b) to whom the transfer, pledge, or release of an uncertificated security is registered on the books of the issuer; or (c) to whom a security is transferred under the provisions of paragraph (c), (d)(i), or (g) or section 8-313(1).

Id.

[156] *Id.* § 8-302(3).

[157] New section 8-303 takes the place of old section 8-302, providing:

> (a) "Protected purchaser" means a purchaser of a certificated or uncertificated security, or of an interest therein, who:
>
> (1) gives value;
>
> (2) does not have notice of any adverse claim to the security; and
>
> (3) obtains control of the certificated or uncertificated security.
>
> (b) In addition to acquiring the rights of a purchaser, a protected purchaser also acquires its interest in the security free of any adverse claim.

U.C.C. § 8-303 (1996). The comparable negotiability rule for the indirect holding system in sections 8-502 and 8-510 of Revised Article 8 also avoids use of the term "good faith" and turns solely on giving value and lack of notice of adverse claims. *Id.* §§ 8-502, 8-510; *see also infra* notes 226-34 and accompanying text.

[158] REVISED ARTICLE 8 OFFICIAL TEXT, *supra* note 2, at 42.

notice of an adverse claim if the purchaser knows of the claim or "is aware of facts sufficient to indicate that there is a significant probability that the adverse claim exists and deliberately avoids information that would establish the existence of the adverse claim."[159] This fine tuning of the basic negotiability rule is intended to enhance finality and thereby serve the overall goal of reducing systemic risk.[160]

4. *Rejection of the* Lowry *Principle: issuer's duty as to adverse claims*

Revised Article 8 eliminates an issuer's potential liability for failure to investigate adverse claims of which it has notice before registering a requested transfer.[161] Under section 8-403

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[159] U.C.C. § 8-105(a)(2) (1996). Professor Rogers maintains that elimination of the "good faith" requirement returns the basic Article 8 negotiability rule to its proper focus on giving value and lack of notice alone. According to Professor Rogers, the separate requirement of "good faith" in section 8-302 of the prior versions of Article 8 was an unfortunate excrescence resulting from a misreading of the historic legal term "bona fide purchaser":

> In the eighteenth- and nineteenth-century negotiable instruments law cases, the term used to describe a person who took free from adverse claims was not "good faith purchaser" but "bona fide purchaser for value and without notice." The requirements for protection were that the purchaser gave value and had no notice of adverse claims. Good faith was not an independent third requirement; indeed, the word "good faith" does not even appear in the classic nineteenth-century English cases in which the courts wrestled with the question whether a purchaser was disqualified from adverse claim protection if the purchaser honestly, but foolishly, did not suspect that there was anything amiss even though the circumstances were such as to have excited the suspicions of a reasonably prudent person. The words "bona fide" in the phrase "bona fide purchaser for value and without notice" did not refer to a separate third requirement. Instead, they served the linguistic function of a modifier of the phrase "for value and without notice," emphasizing that the purchaser must genuinely have given value and must genuinely have been without notice of adverse claims.

Rogers, *Policy Perspectives*, *supra* note 3, at 1470. Professor Rogers goes on to argue that the term "good faith" is needlessly broad and carries far too much extraneous baggage from other legal contexts to safely serve the relatively narrow purpose of preventing willfully blind purchasers from being protected (the most frequently recurring application of the term under Article 8). *Id.* at 1471-73.

[160] *Id.* 1469-73.

[161] REVISED ARTICLE 8 OFFICIAL TEXT, *supra* note 2, at 58-59.

of the 1978 version of Article 8, an issuer could be liable to an adverse claimant if the issuer failed to investigate a claim of which it had written notice before registering a transfer.[162] The issuer could discharge its duty of inquiry by "any reasonable means," including notification of the adverse claimant that the transfer would be registered within thirty days unless an appropriate court order or indemnity bond was delivered to the issuer.[163] Issuer liability for registration of transfer in violation of third-party adverse claims is based on the mid-nineteenth century case of *Lowry v. Commercial & Farmers' Bank*,[164] in which an issuer was held liable for a wrongful transfer where the issuer had reason to believe that the fiduciary requesting the transfer may have been acting improperly.[165] The potential for liability under the *Lowry* principle has led issuers historically to require extensive documentation in connection with stock transfers by fiduciaries (since fiduciary status could be viewed as putting the issuer on notice of other claimants) to ensure that the fiduciaries were acting rightfully.[166] In order to simplify fiduciary stock transactions, modern fiduciary statutes, like the Uniform Fiduciaries Act, the Model Fiduciary Stock Transfer Act, and the Uniform Act for the Simplification of Fiduciary Security Transfers limited issuer lia-

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[162] U.C.C. § 8-403(1) (1978) (amended in 1996). Section 8-403 reads in part:

> An issuer to whom a certificated security is presented for registration shall inquire into adverse claims if:
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> (a) a written notification of an adverse claim is received at a time and in a manner affording the issuer a reasonable opportunity to act on it prior to the issuance of a new, reissued, or re-registered certificated security, and the notification identifies the claimant, the registered owner, and the issue of which the security is a part, and provides an address for communications directed to the claimant; or
>
> (b) the issuer is charged with notice of an adverse claim from a controlling instrument it has elected to require under section 8-402(4).

Id.

[163] *Id.* § 8-403(2).

[164] 15 F. Cas. 1040 (C.C.D. Md. 1848) (No. 8,581).

[165] *Lowry*, 15 F. Cas. at 1048. The issuer was liable to the legatee because the issuer failed to investigate the written will of the original stockholder. *Id.*

[166] Rogers, *Policy Perspectives*, *supra* note 3, at 1533.

bility for wrongful transfers by negating a duty of inquiry based on the fiduciary status of the owner alone, but retained liability if the issuer acted with notice of third-party claims.[167] Section 8-403 of the 1978 version paralleled the principle as confined by the modern fiduciary statutes.[168] The prior version expressly negated any duty of inquiry arising solely from fiduciary status of the registered owner, but it retained a duty to investigate if the issuer had notice of an adverse claim.[169]

Revised Article 8 eliminates issuer liability for wrongful registration altogether if the issuer acts on an effective indorsement or instruction (even though the issuer may have notice of adverse claims)[170] so long as the issuer has not been served with a court order or legal process and is not acting in collusion with the wrongdoer in registering the transfer.[171] The duty to investigate is deleted completely.[172]

5. Elimination of separate statute of frauds

Revised Article 8 eliminates the special statute of frauds for securities contracts contained in section 8-319 of the prior

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[167] REVISED ARTICLE 8 OFFICIAL TEXT, *supra* note 2, at 58.

[168] *Id.*

[169] *Id.* at 58-59.

[170] U.C.C. § 8-404(a) (1996).

[171] *Id.* § 8-404(a)(3)-(4).

[172] *Id.* This reduction in the liability potential of issuers as necessary cogs in the stock transfer machinery is, once again, a measure designed to enhance finality, reduce delays in transfer and, thereby, reduce systemic risk. The Official Comment to section 8-404 of Revised Article 8 notes that this change also serves the basic neutrality principle of Revised Article 8:

> This section applies to the record-keepers for the direct holding system the same standard that Section 8-115 applies to the record-keepers for the indirect holding system. Thus, issuers are not liable to adverse claimants merely on the basis of notice. As in the case of the analogous rules for the indirect holding system, the policy of this section is to protect the right of investors to have their securities transfers processed without the disruption or delay that might result if the record-keepers risked liability to third parties. It would be undesirable to apply different standards to the direct and indirect holding systems, since doing so might operate as a disincentive to the development of a book-entry direct holding system.

Id. § 8-404 cmt. 2.

versions.[173] Most of the litigation under section 8-319 has involved claims by employees or former employees of small firms that they had been promised equity interests in their companies.[174] The special statute of frauds has played a very limited role in the context of the public securities markets.[175] The Official Comment to section 8-113 of Revised Article 8 concludes, in light of technological advances toward a paperless world in general, that "whatever benefits a statute of frauds may play in filtering out fraudulent claims are outweighed by the obstacles it places in the development of modern commercial practices in the securities business."[176]

D. Part 5: Security Entitlements

Part 5 of Revised Article 8 does two things. First, it defines the basic package of rights and duties that make up the new form of property referred to in Revised Article 8 as a "security entitlement." Second, it provides the negotiability and transaction finality rules for security entitlements analogous to those in Parts 2, 3, and 4 for the direct holding system.

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[173] REVISED ARTICLE 8 OFFICIAL TEXT, *supra* note 2, at 59. Not only does Revised Article 8 eliminate former section 8-319, it specifies the absence of a special statute of frauds in new section 8-113, which provides that:

> A contract or modification of a contract for the sale or purchase of a security is enforceable whether or not there is a writing signed or record authenticated by a party against whom enforcement is sought, even if the contract or modification is not capable of performance within one year of its making.

U.C.C. § 8-113 (1996).

[174] REVISED ARTICLE 8 OFFICIAL TEXT, *supra* note 2, at 59. One of the few Mississippi cases dealing substantively with any provision of Article 8 was based on facts involving an alleged contract to sell shares of a closely held corporation. Thomas v. Prewitt, 355 So. 2d 657, 659 (Miss. 1978). The court, construing former section 8-319, found against the proponents of the alleged contract because the agreement was not in writing. *Prewitt*, 355 So. 2d at 660.

[175] REVISED ARTICLE 8 OFFICIAL TEXT, *supra* note 2, at 59. The former section 8-319 applied mostly to informal transactions. *Id.*

[176] U.C.C. § 8-113 cmt. (1996).

1. The basic package of rights and duties

Section 8-501 provides that a security entitlement is acquired or created when a securities intermediary credits a financial asset to the entitlement holder's securities account, thereby undertaking to treat the entitlement holder as entitled to exercise the rights that comprise the financial asset.[177] Sections 8-503 through 8-509 then describe the nature of the indirect holder's property interest in the financial assets credited to his securities account and specify the rights and duties comprising the relationship between the entitlement holder and the securities intermediary.[178] Two things are noteworthy about the approach of Revised Article 8 in defining the intermediary/holder relationship that is the core of the security entitlement. First, Revised Article 8 does not adapt a ready-made type of legal relationship, such as bailment, to this purpose. Instead, it starts from scratch, building the relationship from its basic functional rights and duties.[179] Second, in specifying the rights and duties inherent in the security entitlement, Revised Article 8 does not attempt to encompass or describe comprehensively all aspects of the legal relationship between a securities intermediary and its customer/entitlement holder.[180] Federal securities law, agency law, contract law, insol-

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[177] *See supra* notes 109-22 and accompanying text.

[178] *See* Rogers, *Policy Perspectives*, *supra* note 3, at 1450-51.

[179] This is what Professor Rogers means when he says that "[t]he starting point of the Revised Article 8 approach is to identify, in functional rather than categorical terms, what it means to say that a person holds a security through an intermediary." *Id.* at 1450.

For a comparison of the standards of duty involved in a security entitlement and those imposed under the common law of bailment, the body of property law that presumably governed the relationship between a securities custodian and its customers before Revised Article 8, see Rogers, *Policy Perspectives*, *supra* note 3, at 1505-11.

[180] The introductory note to Revised Article 8 provides:

> Revised Article 8 is not, and should not be, a comprehensive body of private law governing the relationship between brokers and their customers, nor a body of regulatory law to police against improper conduct by brokers or other intermediaries. Many, if not most, aspects of the relationship between brokers and customers are governed by the common law of contract and agency, supplemented or supplanted by federal and state regulatory law.

vency law, and other bodies of law govern aspects of this relationship. Revised Article 8 does not supplant this other law.[181] The elements of the security entitlement set forth in Part 5 are only intended to govern those aspects of the basic commercial and property relationship necessary for the operation of the negotiability and transaction finality rules of Revised Article 8 and the security interest rules of revised Article 9.[182]

This basic package of rights and duties, as specified in sections 8-503 through 8-509, includes:

• *Property interest of entitlement holder; financial assets not subject to general creditors of securities intermediary (section 8-503).* As already noted,[183] section 8-503 specifies the nature of the entitlement holder's property interest in the financial assets credited to the securities account. It provides that

> [t]o the extent necessary for a securities intermediary to satisfy all security entitlements with respect to a particular financial asset, all interests in that financial asset held by the securities intermediary are held by the securities intermediary for the entitlement holders, are not property of the securities intermediary, and are not subject to claims of creditors of the securities intermediary, except as otherwise provided in section 8-511.[184]

It then goes on to describe the nature of an entitlement

REVISED ARTICLE 8 OFFICIAL TEXT, *supra* note 2, at 46.

[181] To some extent, Revised Article 8 incorporates this other law by reference. For example, section 8-509 incorporates applicable standards from statute, regulation, or rule to the duties of securities intermediaries under sections 8-504 through 8-508. U.C.C. § 8-509 (1996).

[182] The Introductory note reads in part:

> Article 8 deals with how interests in securities are evidenced and how they are transferred. By way of rough analogy, one might think of Article 8 as playing the role for the securities markets that real estate recording acts play for the real estate markets. Real estate recording acts do not regulate the conduct of parties to real estate transactions; Article 8 does not regulate the conduct of parties to securities transactions.

REVISED ARTICLE 8 OFFICIAL TEXT, *supra* note 2, at 46.

[183] *See supra* notes 119-22 and accompanying text.

[184] U.C.C. § 8-503(a) (1996).

holder's interest with respect to a particular financial asset as "a pro rata property interest in all interests in that financial asset held by the securities intermediary, without regard to the time the entitlement holder acquired the security entitlement or the time the securities intermediary acquired the interest in that financial asset."[185] The entitlement holder has a pro rata interest in common with all other entitlement holders of a particular financial asset through the particular securities intermediary in the fungible bulk of that financial asset held by the securities intermediary either directly or indirectly. The pro rata common interest relates to a particular type or issue of financial asset, not to identifiable or traceable units of that type or issue of financial asset.[186] Particular financial assets (*e.g.*, particular shares of stock) are not traceable to particular entitlement holders.[187] A particular bulk of assets is not even traceable to a particular group of entitlement holders as of a particular moment in time.[188] Earlier entitlement holders

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[185] *Id.*

[186] *Id.* § 8-503 cmt. 1.

[187] This is a fundamental difference between the direct holding system rules and the indirect holding system rules in Revised Article 8. As the comments to section 8-503 explain:

> Although this section recognizes that the entitlement holders of a securities intermediary have a property interest in the financial assets held by the intermediary, the incidents of this property interest are established by the rules of Article 8, not by common law property concepts. The traditional Article 8 rules on certificated securities were based on the idea that a paper certificate could be regarded as a nearly complete reification of the underlying right. The rules on transfer and the consequences of wrongful transfer could then be written using the same basic concepts as the rules for physical chattels. A person's claim of ownership of a certificated security is a right to a specific identifiable physical object, and that right can be asserted against any person who ends up in possession of that physical certificate, unless cut off by the rules protecting purchasers for value without notice. Those concepts do not work for the indirect holding system. A security entitlement is not a claim to a specific identifiable thing; it is a package of rights and interests that a person has against the person's securities intermediary and the property held by the intermediary. The idea that discrete objects might be traced through the hands of different persons has no place in the Revised Article 8 rules for the indirect holding system.

Id. § 8-503 cmt. 2.

[188] *See id.* § 8-503 cmt. 1 ("Temporal factors are irrelevant One entitlement

have the same pro rata common interest as later entitlement holders.

The remainder of section 8-503 specifies precisely what legal rights this property interest in the financial assets gives the entitlement holder. Subsection (c) provides that "an entitlement holder's property interest [may be asserted] against the intermediary only by exercise of the entitlement holder's rights under sections 8-505 through 8-508," the sections imposing duties on the intermediary to pass on all economic and corporate rights comprising the financial asset to the entitlement holder.[189] These duties only repose on the securities intermediary of the entitlement holder, and the entitlement holder is the only person to whom the securities intermediary owes these duties.[190] Subsection (d) specifies the only circumstances in which the entitlement holder may assert a claim based on the holder's property interest against a third-party purchaser to whom the securities intermediary transfers a financial asset (or interest therein) that was subject to a security entitlement in the hands of the intermediary. In order for such a third-party claim to be brought, the intermediary must be in insolvency proceedings, must not have "sufficient interests in the financial asset" to cover all of its security entitlements, must have transferred the financial asset (or interest therein) in violation of its duties under section 8-504 (to maintain sufficient interests in the financial asset to cover all security entitlements), and the purchaser must not be a protected purchaser under subsection (e).[191] Subsection (e) provides that a purchaser of a financial asset from an intermediary is a protected purchaser if the purchaser gives value, obtains control and does not act in collusion with the intermediary in violating section 8-504.[192]

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holder cannot claim that its rights to the assets held by the intermediary are superior to the rights of another entitlement holder by virtue of having acquired those rights before, or after, the other entitlement holder. . . . Rather, all entitlement holders have a pro rata interest in whatever positions in that financial asset the intermediary holds.").

[189] U.C.C. § 8-503 cmt. 2 (1996).

[190] *Id.* §§ 8-115, 8-115 cmt. 4.

[191] *Id.*

[192] *Id.* § 8-503(e).

The extreme limitation in subsections (d) and (e) on claims against third parties is consistent with the Revised Article 8 policy of reducing systemic risk in the securities markets. In the event of an intermediary's insolvency, an entitlement holder may not pursue a purchaser of a financial asset (or interest therein) unless the purchaser acted in collusion with (*i.e.*, was "in cahoots with")[193] the intermediary in the transfer which deprived the entitlement holders of sufficient interests in the asset to meet all entitlement needs. The collusion requirement is intended to eliminate any notion of a duty to investigate on the part of the purchaser that might be inferred from a notice-of-adverse-claim standard.[194] It is also intended to build a fire wall around the failed intermediary to prevent the spread of its failure and the possible shifting of loss from one set of investors to another.[195] Together, subsections (c), (d), and (e) em-

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[193] Rogers, *Policy Perspectives*, *supra* note 3, at 1501. According to Professor Rogers, the collusion standard was intended to embody the "general notion summed up in" this colloquial phrase. *Id.*

[194] *See* U.C.C. § 8-503 cmt. 3 (1996) (discussing collusion requirement). This negation of duty to investigate, which parallels the elimination of all vestiges of the *Lowry* doctrine from the direct holding rules in Part 4, is explained in the Official Comment to section 8-503:

> The use of the collusion test in section 8-503(e) furthers the interests of investors generally in the sound and efficient operation of the securities holding and settlement system. The effect of the choice of this standard is that customers of a failed intermediary must show that the transferee from whom they seek to recover was affirmatively engaged in wrongful conduct, rather than casting on the transferee any burden of showing that the transferee had no awareness of wrongful conduct by the failed intermediary. The rule of section 8-503(e) is based on the long-standing policy that it is undesirable to impose upon purchasers of securities any duty to investigate whether their sellers may be a acting wrongfully.

Id.

[195] *Id.* The Official Comment to section 8-503 gives an example of this effect:

> Suppose, for example, that Intermediary A transfers securities to B, that Intermediary A acted wrongfully as against its customers in so doing, and that after the transaction Intermediary A did not have sufficient securities to satisfy its obligations to its entitlement holders. Viewed solely from the standpoint of the customers of Intermediary A, it would seem that permitting the property to be recovered from B, would be good for investors. That, however, is not the case. B may itself be an intermediary with its own customers, or may be some other institution

body a fundamental truism of the indirect holding system: the investor who chooses to hold securities indirectly accepts the risk that the investor's intermediary will not live up to its duties as intermediary.[196]

Section 8-511 provides additional elucidation of the entitlement holder's basic property rights by setting out the priority rules for situations in which an intermediary fails, holding insufficient assets to satisfy both the claims of its entitlement holders and the claims of its creditors with security interests in such assets.[197] Under section 8-511(a), entitlement holder claims have priority over the claims of secured creditors in this situation.[198] However, under section 8-511(b), a secured creditor that has *control* (within the meaning of section 8-106) over the financial assets in question has priority over the claims of entitlement holders.[199] Even where a pledge is wrongful in that it involves financial assets that should be maintained for entitlement holders, the secured creditor has priority so long as the secured creditor has control.[200] Only in the rare case in

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> through which individuals invest, such as a pension fund or investment company. There is no reason to think that rules permitting customers of an intermediary to trace and recover securities that their intermediary wrongfully transferred work to the advantage of investors in general. To the contrary, application of such rules would often merely shift losses from one set of investors to another.

Id.

[196] *See* Rogers, *Policy Perspectives*, *supra* note 3, at 1455 (stating "[T]he principle that an entitlement holder can look only to its own intermediary is not really a creation of Revised Article 8. Revised Article 8 only gives legal recognition to the factual realities of the modern securities holding system. In a multi-tiered system of intermediaries, only a person's own immediate intermediary knows anything about that person's interest").

[197] U.C.C. § 8-511 cmt. 1 (1996).

[198] *Id.* § 8-511(a). According to Professor Rogers, clarification of the subordination of secured creditors (without control) to entitlement holders in this situation is a new, pro-investor feature of Revised Article 8. Rogers, *Policy Perspectives*, *supra* note 3, at 1524. The law on this point was not clear before. *Id.* at 1526-27; *see infra* notes 283-87 and accompanying text.

[199] U.C.C. § 8-511(b) (1996).

[200] Such a pledge of financial assets would not only breach the duty of the intermediary to its entitlement holders under section 8-504, *see infra* notes 197-205 and accompanying text, but it would also violate the regulatory requirements applicable to registered broker-dealers in Rules 8c-1, 15c2-1 and 15c3-3 under the Securities Exchange Act of 1934. *See id.* § 8-511 cmt. 2 (discussing applicable

which the creditor was in collusion with the intermediary would the entitlement holders have a potential claim against the creditor under section 8-503(d).[201]

• *Duty of securities intermediary to maintain sufficient quantity of financial asset to cover all security entitlements (section 8-504).* Section 8-504(b) imposes on the securities intermediary a duty to "promptly obtain and thereafter maintain a financial asset in a quantity corresponding to the aggregate of all security entitlements it has established in favor of its entitlement holders with respect to that financial asset."[202] The securities intermediary is free to maintain those financial assets "directly or through one or more other securities intermediaries."[203] As a corollary to the basic duty found in subsection (a), subsection (b) goes on to prohibit a securities interme-

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SEC rules).

[201] *Id.* § 8-511 cmt. 1. Although entitlement holders of a failed intermediary may have no recourse against purchasers or pledgees, they may be entitled to insurance protection under the Securities Investor Protection Act ("SIPA"). *Id.* The Official Comment to section 8-511 provides that:

> Securities firms required to register as brokers or dealers are also required to become members of the Securities Investor Protection Corporation ("SIPC"), which provides their customers with protection somewhat similar to that provided by FDIC and other deposit insurance programs for bank depositors. When a member firm fails, SIPC is authorized to initiate a liquidation proceeding under the provisions of SIPA. If the assets of the securities firm are insufficient to satisfy all customer claims, SIPA makes contributions to the estate from a fund financed by assessments on its members to protect customers against losses up to $500,000 for cash and securities held at member firms.

Id. § 8-511 cmt. 2.

Although the rule in section 8-511(b) appears to be solicitous of broker-dealers and lenders and surprisingly unprotective of investors, Professor Rogers makes a convincing case that the net change effected by section 8-511 is in favor of the position of customers. *See* Rogers, *Policy Perspectives*, *supra* note 3, at 1524 (stating "[o]ne of the ironies of the common reactions of casual readers of Revised Article 8 is that the provision that most often excites concern — section 8-511 — is a provision that is included only because of the decision of the drafting committee to include a new provision in Article 8 that subordinates the claims of secured creditors to those of customers in one common category of financing transaction"). For an explanation of his position and how the previous rules and Revised Article 8 rules operate in the practical reality of lending practices in the securities industry, see *id.* at 1511-40.

[202] U.C.C. § 8-504(a) (1996).

[203] *Id.*

diary from granting any security interests in a financial asset it is obligated to maintain to cover security entitlements, unless the entitlement holder has so agreed.[204]

Subsection (c) provides that a securities intermediary satisfies this duty (1) if it acts with respect to such duty in accordance with an agreement between the intermediary and the entitlement holder, or (2) in the absence of such an agreement, if it "exercises due care in accordance with reasonable commercial standards."[205] This agreement/due care formulation is used as the standard of performance required in each of the core duties owed by the securities intermediary to the entitlement holder under Part 5. This standard of care, whether established by agreement or the statutory due care standard, is subject to, and shaped by, the general obligation of good faith performance under sections 1-203 and 8-102(a)(10).[206] The Official Comment to section 8-504 notes that "[i]t would not be consistent with the obligation of good faith performance for an agreement to purport to establish the usual sort of arrangement between an intermediary and entitlement holder, yet disclaim altogether one of the basic elements that define that relationship."[207] Section 8-509 provides that where "the sub-

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[204] *Id.* § 8-504(b). "Except to the extent otherwise agreed by its entitlement holder, a securities intermediary may not grant any security interests in a financial asset it is obligated to maintain pursuant to subsection (a)." *Id.*

[205] *Id.* § 8-504(c).

[206] Section 1-203 of the UCC provides that "every . . . duty within this Act imposes an obligation of good faith in its performance." *Id.* § 1-203. "Good faith" in the performance of contracts or duties (under Revised Article 8) is defined in section 8-102(a)(10) of the U.C.C. as "honesty in fact and the observance of reasonable commercial standards of fair dealing." *Id.* § 8-102(a)(10). This duty of good faith in performance, according to Professor Rogers, applies not only to the performance of the statutory duty but also to the making of an agreement as a means of carrying out the duty:

> Making an agreement specifying the details of the intermediary's duties and performing in accordance with that agreement would be a method by which the intermediary seeks to carry out its statutory duty. Whether action taken in accordance with such an agreement is sufficient depends on whether that action can be said to satisfy the obligation of good faith performance of the underlying statutory duty.

Rogers, *Policy Perspectives*, *supra* note 3, at 1507-08.

[207] U.C.C. § 8-504 cmt. 4 (1996).

stance of a duty imposed upon a securities intermediary by sections 8-504 through 8-508 is the subject of other statute, regulation, or rule, compliance with that statute, regulation, or rule satisfies the duty."[208] The intermediary's broad duties in section 8-504 are also the subject of the detailed requirements imposed in Rules 8c-1, 15c2-1, and 15c3-3 under the Securities Exchange Act of 1934 on broker-dealers registered under federal securities laws.[209] These rules would therefore provide the detailed compliance standards for the duties in section 8-504.[210]

• *Duty of securities intermediary to pass through payments or distributions made by issuer of financial assets to entitlement holders (section 8-505).* Section 8-505 imposes on the securities intermediary the duty to obtain payments or distributions made by the issuer of financial assets.[211] The duty is satisfied if the intermediary complies with the agreement/due care standard discussed above.[212] The intermediary is obligated to the entitlement holder for the payments or distributions so obtained.[213]

• *Duty of securities intermediary to exercise rights if directed by entitlement holders (section 8-506).* Section 8-506 requires a securities intermediary to exercise voting and other rights (*e.g.,* conversion, redemption, or exchange rights) with respect to a financial asset if directed to do so by an entitlement holder.[214] The duty is satisfied if the intermediary complies with the agreement/due care standard discussed above, but section 8-506 also permits the intermediary to satisfy the standard with respect to a particular right by putting the entitlement holder in a position to exercise the right directly.[215] An intermediary's involvement in voting of publicly held equity

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[208] *Id.* § 8-509(a).

[209] *See id.* § 8-504 cmt. 5 (discussing additional statutory duties of broker-dealers).

[210] *Id.* § 8-504 cmt. 5.

[211] *Id.* § 8-505(a).

[212] U.C.C. § 8-505(a)(1)-(2) (1996).

[213] *Id.* § 8-505(b).

[214] *Id.* § 8-506.

[215] *Id.* § 8-506(1)-(2).

securities is subject to extensive, complex regulation under the SEC's proxy rules and the rules of the NYSE, AMEX, and the NASD.[216] Under section 8-509(a), compliance with such regulation will constitute compliance with the section 8-506 duty.[217]

• *Duty of securities intermediary to transfer or otherwise dispose of financial assets as directed by entitlement holders (section 8-507).* Section 8-507(a) imposes a duty on a securities intermediary to "comply with an entitlement order if the entitlement order is originated by the appropriate person, the securities intermediary has had reasonable opportunity to assure itself that the entitlement order is genuine and authorized, and the securities intermediary has had reasonable opportunity to comply with the entitlement order."[218] The duty is satisfied if the intermediary complies with the agreement/due care standard discussed above.[219] Section 8-507(b) requires that a securities intermediary that has transferred financial assets pursuant to an "ineffective entitlement order" reestablish a security entitlement in favor of the person entitled to it and pay or credit such person's account for proceeds not received as a result of the wrongful transfer, or be liable to the entitlement holder for damages.[220]

"Entitlement order" is defined in section 8-102(a)(8) as "a notification communicated to a securities intermediary directing transfer or redemption of a financial asset to which the entitlement holder has a security entitlement."[221] An entitlement order serves the same function for indirectly held securities under Revised Article 8 as an "indorsement" serves for certificated securities and an "instruction" serves for uncertificated securities in the direct holding system.[222] The entitlement order is the means of effecting a transfer. The only "appropriate person" for purposes of originating an entitlement

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[216] *See supra* note 62.
[217] U.C.C. § 8-506 cmt. 4 (1996).
[218] *Id.* § 8-507(a).
[219] *Id.* § 8-507(a)(1)-(2).
[220] *Id.* § 8-507(b).
[221] *Id.* § 8-102(a)(8).
[222] U.C.C. § 8-102 cmt. 8 (1996).

order is the entitlement holder.[223] An entitlement order may, however, be "effective" if made by the entitlement holder or an authorized agent of the entitlement holder.[224]

Consequently, the securities intermediary's duty to act in accordance with an entitlement order under section 8-507(a) runs only to the entitlement holder, since the duty applies only to an entitlement order originating from an appropriate person.[225] A securities intermediary is not obligated under section 8-507(a) to determine at its peril whether a person who purports to be an authorized agent of the entitlement holder is, in fact, an authorized agent. Even a duly authorized agent is not an appropriate person. On the other hand, the securities intermediary will not be exposed to liability under section 8-507(b) if it complies with an entitlement order made by a duly authorized agent, since an entitlement order made by an authorized agent is "effective." Under the perfection provisions of revised Article 9, an entitlement holder may enter into a three-way agreement with a secured lender and the securities intermediary authorizing the secured lender to submit entitlement orders to the intermediary and directing the intermediary to comply with such orders. Such an agreement confers "control" on the secured lender[226] and perfects its security interest in the financial assets.[227] For purposes of section 8-507, when the secured lender submits an entitlement order pursuant to the control agreement, the securities intermediary can act in accordance with it without exposure to liability under section 8-507(b) (because the entitlement order is "effective") and without violating its duty to the entitlement holder under section 8-507(a) (because the intermediary has acted in conformity with

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[223] *Id.* § 8-107(a)(3). The definition of "appropriate person" also includes the entitlement holder's designated successor or personal representative in the event of death and the entitlement holder's guardian, conservator or other similar representative in the event of incapacity. *Id.* § 8-107(a)(4)-(5).

[224] *Id.* § 8-107(b).

[225] *Id.* § 8-507 cmt. 3.

[226] *See id.* § 8-106(d) (stating "[a] purchaser has 'control' of a security entitlement if . . . the securities intermediary has agreed that it will comply with entitlement orders originated by the purchaser without further consent by the entitlement holder").

[227] U.C.C. § 9-115(4)(a) (1996).

the agreement/due care standard).[228]

• *Duty of securities intermediary to change entitlement holder's position to any other available form of security holding upon request (section 8-508).* A securities intermediary has the duty, under section 8-508 of Revised Article 8, to "act at the direction of an entitlement holder to change a security entitlement into another available form of holding for which the entitlement holder is eligible, or to cause the financial asset to be transferred to a securities account of the entitlement holder with another securities intermediary."[229] The duty is satisfied if the intermediary complies with the agreement/due care standard discussed above. This duty would require the securities intermediary, for example, to deliver a certificate registered in the entitlement holder's name if so requested, unless the particular security in question was not available in certificated form.[230]

2. *Negotiability and transaction finality*

Sections 8-502 and 8-510 provide the basic adverse claim cut-off rules for the indirect holding system that section 8-303 provides for the direct holding system.[231] Section 8-502 provides that "[a]n action based on an adverse claim to a financial asset . . . may not be asserted against a person who acquires a security entitlement under section 8-501 for value and without notice of the adverse claim."[232] Because securities trades in

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[228] *Id.* § 8-507 cmt. 3.

[229] *Id.* § 8-508.

[230] *Id.* § 8-508 cmt. 1.

[231] *Id.* § 8-502 cmt. 1. For discussion of section 8-303, see *supra* notes 154-59 and accompanying text.

[232] U.C.C. § 8-502 (1996). As in the case of section 8-303, the adverse claim cut-off requirements in sections 8-502 and 8-510 omit any explicit reference to good faith or *bona fides*. For a discussion of the reasons for this omission, *see supra* notes 158-59, *supra,* and accompanying text. The wording of section 8-502, however, varies somewhat from the wording of section 8-303. The Official Comment explains:

> This section does not use the locution "takes free from adverse claims" because that could be confusing as applied to the indirect holding system. The nature of indirect holding system is that an entitlement holder has an interest in common with others who hold positions in the same

the public market are "settled on a net basis by book-entry movements,"[233] adverse claims against an entitlement holder with respect to a particular financial asset would involve very unlikely fact situations in which the claimant was actually able to trace a particular financial asset to a particular entitlement holder.[234] While section 8-502 provides the entitlement holder with protection from theoretical adverse claims with respect to particular financial assets, it does nothing to protect the entitlement holder from the risk that the holder's intermediary may become insolvent with insufficient financial assets to cover all its securities entitlements. In such event, the entitlement holder would have a claim against the intermediary under section 8-504 or against a collusive purchaser of financial assets to the extent permitted under section 8-503(d). Section 8-502 would preclude any claim by an earlier entitlement holder against a later entitlement holder of the same intermediary based on dilution of the earlier holder's pro rata right to the

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> financial asset through the same intermediary. Thus, a particular entitlement holder's interest in the financial assets held by its intermediary is necessarily "subject to" the interests of others.

U.C.C. § 8-502 cmt.1 (1996).

[233] *Id.* § 8-502 cmt. 2; *see supra* notes 68-74 and accompanying text.

[234] U.C.C. § 8-502 cmt. 2 (1996). The Official Comment clarifies the impediments to such adverse claims:

> Suppose, for example, that S has a 1000 share position in XYZ common stock through an account with a broker, Able & Co. S's identical twin impersonates S and directs Able to sell the securities. That same day, B places an order with Baker & Co., to buy 1000 shares of XYZ common stock. Later, S discovers the wrongful act and seeks to recover "her shares." Even if S can show that, at the stage of the trade, her sell order was matched with B's buy order, that would not suffice to show that "her shares" went to B. Settlement between Able and Baker occurs on a net basis for all trades in XYZ that day; indeed Able's net position may have been such that it received rather than delivered shares in XYZ through the settlement system.

Id. The practical implausibility of such adverse claims is illustrated by the bizarre examples in the Official Comment to section 8-502. *See id.* § 8-502 cmt. 3; *see also* Sandra M. Rocks, *Revisions to the United States Uniform Commercial Code Governing Transactions in Securities and Other Investment Property*, SA80 A.L.I.A.B.A. 221, 227 (1996) (stating predecessor provision and new § 8-502 have "more force in theory than in practice, since [their] usefulness depends upon the ability to trace the securities in question").

insufficient quantity of assets held by the intermediary.[235]

The more significant Part 5 adverse claim cut-off rule is in section 8-510, which gives "protection to persons who take security interests in security entitlements and obtain control [within the meaning of section 8-106] but do not themselves become entitlement holders."[236] Section 8-510 provides that an "action based on an adverse claim to a financial asset or security entitlement . . . may not be asserted against a person who purchases a security entitlement, or an interest therein, from an entitlement holder if the purchaser gives value, does not have notice of the adverse claim, and obtains control."[237]

If a bank makes a loan to an entitlement holder and perfects a security interest in the security entitlement by obtaining control under section 8-106(d)(2) through a contract in which the intermediary agrees to comply with entitlement orders originated by the bank, the bank is protected from adverse claims under section 8-510.[238] If the bank only perfects

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[235] U.C.C. § 8-502 cmt. 4 (1996). This point is really inherent in the basic nature of the entitlement holder's property interest in the financial assets, as described in section 8-503(b): the entitlement holder has a "pro rata property interest in all interests in that financial asset held by the securities intermediary, without regard to the time the entitlement holder acquired the security entitlement or the time the securities intermediary acquired the interest in that financial asset." *Id.* § 8-503(b).

[236] *Id.* 8-510 cmt. 2.

[237] *Id.* § 8-510(a). In addition to the basic adverse claim cut-off rule in section 8-510(a), section 8-510(b) applies a limited version of the "shelter principle" to indirect holding system transactions, providing that "[i]f an adverse claim could not have been asserted against an entitlement holder under section 8-502, the adverse claim cannot be asserted against a person who purchases a security entitlement, or an interest therein, from the entitlement holder." *Id.* § 8-510(b). Official comments provide an example of the "relatively limited class of cases" for which coverage under section 8-510(b) would be the exclusive means of adverse claim cut-off. *See id.* § 8-510 cmt. 3 (illustrating "shelter principle").

A priority rule for conflicting interests in the same security entitlement in those limited cases not covered by the security interest rules of revised Article 9 is set forth in section 8-510(c). The Official Comment notes that the rule in section 8-510(c) is intended primarily for disputes over conflicting claims relating to repurchase agreement transactions ("repos"). *Id.* § 8-510 cmt. 4. The rule is a mirror image of the priority rules for conflicting security interests in section 9-115 of revised Article 9. U.C.C. § 8-510 cmt. 4 (1996); *see also infra* notes 288-96 and accompanying text.

[238] U.C.C. § 8-510 cmt. 2 (1996).

by filing a financing statement, the bank is not protected under section 8-510.[239] On the other hand, if the bank becomes the entitlement holder itself with respect to the financial assets constituting the collateral, the bank is protected from adverse claims under section 8-502.

E. Revised Article 9: Security Interests in Investment Property

The provisions of revised Article 9 dealing with security interests in "investment property"[240] are contained almost exclusively in new sections 9-115 and 9-116.[241] The other revisions scattered throughout Article 9 are primarily for the purpose of excluding "investment property" from the definitions of other categories of collateral treated in Article 9, such as goods,[242] instruments,[243] and general intangibles.[244]

The concept of "control" as defined in section 9-106, which plays a crucial role in the application of the adverse claim cut-off rules of Revised Article 8,[245] also plays a key role with respect to attachment, perfection, and priority under the investment property provisions of revised Article 9. In a nutshell, a secured party who obtains control of a security in security entitlement, or other item of investment property has a perfected

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[239] *See id.* (noting perfection of security interest without obtaining control insufficient to invoke protection of section 8-510(a)).

[240] *Id.* § 9-115(1)(f). The term "investment property" is defined in section 9-115(1)(f) to include "(i) a security, whether certificated or uncertificated; (ii) a security entitlement; (iii) a securities account; (iv) a commodity contract; or (v) a commodity account." *Id.* § 9-115(1)(f). For discussion of this new definition, as well as the related definitions of "security", "security entitlement" and "securities account," see *supra* notes 93-132 and accompanying text.

[241] U.C.C. §§ 9-115-116 (1996). The new provisions are concentrated in these new sections instead of being spread throughout the Article 9 provisions dealing with these topics in relation to other types of collateral in order to minimize the need to renumber sections and subsections. *Id.* § 9-115 cmt. 1.

[242] *Id.* § 9-105(1)(h).

[243] *Id.* § 9-105(1)(i).

[244] *Id.* § 9-106.

[245] *See supra* notes 154-59, 226-34 and accompanying text. For discussion of the role of control in the adverse claim cut-off rules applicable to the direct holding system (section 8-303) and the indirect holding system (sections 8-502, 8-503, and 8-510) under Revised Article 8, *see supra* 154-59, 226-34 and accompanying text.

security interest in that property.[246] That security interest gives priority over conflicting non-control security interests in the same investment property[247] and will be treated as equal to any conflicting control security interest in the same investment property,[248] other than a security interest granted to the owner's intermediary,[249] regardless of the time the security interest was perfected and regardless of the secured party's awareness of conflicting security interests.[250] Understanding the treatment of investment property under revised Article 9, therefore, must begin with an understanding of the concept of control as defined in section 8-106.

1. Control

Basically, obtaining "control" as defined in section 8-106 means the secured party "has taken whatever steps are necessary, given the manner in which the [investment property is] held, to place itself in a position where it can have the [investment property] sold, without further action by the owner."[251]

•*Certificated securities.* A secured party obtains control of certificated securities either (1) by taking delivery[252] of the certificate with effective indorsement, or (2) by becoming the registered holder of the certificated security on the records of the issuer.[253] The control concept therefore encompasses the traditional possessory pledge of certificated securities. It also

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[246] U.C.C. § 9-203(1)(a) (1996) (defining attachment by control); *id.* § 9-115(1)(c) (noting perfection by control); *see infra* notes 278-87 and accompanying text.

[247] U.C.C. § 9-115(5)(a) (1996); *see infra* notes 288-96 and accompanying text.

[248] U.C.C. §§ 9-115(5)(c)-(d) (1996); *see infra* notes 288-96 and accompanying text.

[249] U.C.C. § 9-115(5)(c) (1996); *see infra* notes 291-92 and accompanying text.

[250] U.C.C. § 9-115(5)(c), 9-115 cmt. 5 (1996); *see infra* notes 290-96 and accompanying text.

[251] U.C.C. § 8-106 cmt. 1 (1996).

[252] *Id.* § 8-301(a). For certificated securities, "delivery" is defined in section 8-301 as occurring when a secured party takes possession of the security certificate or an agent takes possession on behalf of the secured party, or "having previously taken possession of the certificate, acknowledges that it holds for the [secured party]." *Id.*

[253] *Id.* § 8-106(b)(2). A secured party obtains control of a certificated security in *bearer* form if the certificated security is delivered to the purchaser. *Id.* §§ 8-106(a), 8-301(a).

encompasses an arrangement whereby the secured party actually becomes the registered holder. In this latter case, so far as the issuer is concerned, the secured party would then be entitled to exercise all rights of ownership.[254] As between the parties, however, allocation of ownership rights would depend on the terms of the arrangement.[255]

•*Uncertificated securities.* For uncertificated securities, a secured party obtains control either (1) by becoming the registered holder on the records of the issuer,[256] or (2) by getting the issuer to "agree that it will comply with instructions originated by the [secured party] without further consent by the registered owner."[257] Under the first method, the secured party actually becomes the registered owner. Again, as far as the issuer is concerned, the secured party would, under such an arrangement, be entitled to all rights of ownership.[258] As between the parties, however, allocation of ownership rights would depend on the terms of the arrangement. As previously noted,[259] Revised Article 8 did away with the "registered pledge" provisions included in the 1978 version. Under those provisions, all issuers of uncertificated securit[ies] were required to offer procedures permitting registration of pledgees as such on the issuers' records while the pledgor remained the registered owner of the securities.[260] Under Revised Article 8, registered pledge arrangements are neither required nor prohibited.[261] The second method of obtaining control under sec-

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[254] *Id.* § 8-106 cmt. 3.

[255] *Id.*

[256] U.C.C. § 8-106(c)(1) (1996). Section 8-106(c)(1) actually provides that control is obtained if the uncertificated security is "delivered" to the secured party. *Id.* Under section 8-301(b), "delivery" of an uncertificated security occurs when: "(1) the issuer registers the [secured party] as the registered owner . . . or (2) another person, other than a securities intermediary, either becomes the registered owner of the uncertificated security on behalf of the [secured party] or, having previously become the registered owner, acknowledges that it holds for the purchaser." *Id.* § 8-302(b).

[257] U.C.C. § 8-106(c)(2) (1996).

[258] *See id.* § 8-106 cmt. 3.

[259] *See supra* notes 146-53 and accompanying text.

[260] *See* REVISED ARTICLE 8 OFFICIAL TEXT, *supra* note 2, at 36-37.

[261] *Id.* at 36.

tion 8-106 contemplates something similar to the registered pledge arrangement: a three-party agreement between the debtor, the secured party, and the issuer in which the issuer promises to comply with instructions originated by the secured party without further consent of the debtor/registered owner.[262] Entering into such a three-party agreement gives the secured party control even if the debtor/registered owner also "retains the right . . . to originate instructions . . . to the issuer . . . or otherwise to deal with the uncertificated securities" and even if other secured parties also have such control agreements.[263] Nothing in Revised Article 8 obligates issuers to enter into such three-party control agreements upon request.[264]

•*Security entitlements.* A secured party has control of a security entitlement if: "(1) the [secured party] becomes the entitlement holder; or, (2) the securities intermediary has agreed that it will comply with entitlement orders originated by the [secured party] without further consent by the entitlement holder."[265] Under the first method, the secured party obtains control whether it becomes the entitlement holder through the debtor's own intermediary or has the financial asset position credited to its account at another intermedi-

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[262] U.C.C. § 8-106(g) (1996). Consent of the debtor/registered owner would be required in order for the issuer to enter into such an agreement with the secured party. *Id.*

[263] *Id.* § 8-106(f). "The key to the control concept is that the purchaser has the present ability to have the securities sold or transferred without further action by the transferor. There is no requirement that the powers held by the purchaser be exclusive." *Id.* § 8-106 cmt. 7.

[264] *Id.* § 8-106 cmt. 3. Commentators note that:

> Under the rules of Revised Articles 8 and 9, the registered pledge issue can easily be left to resolution by the market. The concept of control is defined in such fashion that if an issuer or securities intermediary wishes to offer a service akin to the registered pledge device it can do so. The issuer . . . would offer to enter into agreements with the debtor and secured party under which it would hold the securities for the account of the debtor, but subject to instructions from the secured party. The secured party would thereby obtain control assuring perfection and priority of its lien.

REVISED ARTICLE 8 OFFICIAL TEXT, *supra* note 2, at 36-37.

[265] U.C.C. § 8-106(d) (1996).

ary.[266] The second method contemplates a three-party control agreement between the debtor/entitlement holder, the secured party, and the securities intermediary in which the intermediary promises to comply with entitlement orders originated by the secured party.[267] As in the case of the analogous three-party control agreement for uncertificated securities, the three-party control agreement for security entitlements need not give the secured party exclusive rights to originate entitlement orders.[268] The entitlement holder may retain the right; and, control may be given to more than one secured party at a time through such agreements.[269] Nothing in Revised Article 8 obligates securities intermediaries to enter into such three-party control agreements upon request, although comparable agreements were already standard practice for some intermediaries before the development of Revised Article 8.[270]

•*Securities accounts.* Securities accounts are included in the definition of investment property in order to facilitate the description of collateral in security agreements or financing statements in cases in which the debtor/entitlement holder is granting a security interest in all the financial asset positions in its securities account.[271] A security interest in a securities account not only constitutes a security interest in each of the security entitlements making up the account, but also covers all other rights of the debtor/entitlement holder against the

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[266] *Id.* § 8-106 cmt. 4.

[267] *Id.* A securities intermediary may not enter into such an agreement with a secured creditor without the consent of the debtor/entitlement holder. *Id.* § 8-106(g).

[268] *Id.* § 8-106(f). "There is no requirement that the control party's right to give entitlement orders be exclusive." *Id.* § 8-106 cmt. 4.

[269] *Id.*

[270] U.C.C. § 9-115 cmt. 4 (1996).

[271] *Id.* The comment to section 9-115 provides that:

> Just as a debtor may grant a security interest either in specifically listed items of equipment or in all of the debtor's equipment, so too a debtor who holds securities or other financial assets through a securities account may grant a security interest either in specifically listed security entitlements or in all of the security entitlements held through that account. Referring to the collateral as the securities account is a simple way of describing all of the security entitlements carried in the account.

Id.

securities intermediary arising out of the securities account, including credit balances due to the debtor/entitlement holder from the securities intermediary, whether or not they are proceeds of the security entitlement.[272] A secured party obtains control of a securities account in either of the two ways that it obtains control of the security entitlements that comprise it: the secured party becomes the entitlement holder or obtains a three-party control agreement.[273]

•*Commodity contracts and accounts.* As previously discussed,[274] the revised Article 9 definition of investment property includes commodity contracts and commodity accounts, even though they are neither "securities" nor "security entitlements" nor "financial assets" and, consequently, are not governed by any of the provisions of Revised Article 8. As the Official Comment to section 9-115 notes, commodity contracts are generally very different in nature from securities and security entitlements:

> A person who enters into a commodity futures contract is not buying an asset having a certain value and holding it in anticipation of increase in value. Rather the person is entering into a contract to buy or sell a commodity at set price for delivery at a future time. That contract may become advantageous or disadvantageous as the price of the commodity fluctuates during the term of the contract. The rules of the commodity exchanges require that the contracts be marked to market on a daily basis, that is the customer pays or receives any increment attributable to that day's price change. . . .
>
> The most likely setting in which a person would want to take a security interest in a commodity contract is where a

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[272] *Id.* § 9-115 cmt. 4.

[273] *Id.* § 9-115(1)(e). The comment to section 9-115 reads in part:

> Subsection (1)(e) provides that a secured party has control over a securities account if it has control over all security entitlements carried in the account. Thus, the rules in section 8-106(d) on control with respect to security entitlements determine whether a secured party has control over a securities account. Control with respect to a securities account is defined in terms of obtaining control over the security entitlements simply for drafting convenience.

Id. § 9-115 cmt. 4.

[274] *See supra* notes 128-32 and accompanying text.

> lender who is advancing funds to finance an inventory of a physical commodity requires the borrower to enter into a commodity contract as a hedge against the risk of decline in the value of the commodity. The lender will want to take a security interest in both the commodity itself and the hedging commodity contract. Typically, such arrangements are structured as security interests in the entire commodity account in which the borrower carries the hedging contracts, rather than in individual contracts.[275]

Under section 9-115(1)(e), a secured lender may obtain control of a commodity contract or account by obtaining an agreement among the commodity customer, the secured party and the commodity intermediary in which the intermediary promises to apply any value distributed as directed by the secured party.[276] According to the Official Comment, the provision for this type of three-party control agreement sets out a "clear and certain legal framework for practices that have already developed in the industry."[277]

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[275] U.C.C. § 9-115 cmt. 8 (1996).

[276] *Id.* § 9-115(1)(e).

[277] *Id.* § 9-115 cmt. 8. Part of the logic of including commodity contracts and accounts within the definition of investment property is that there should be coordination between the security interest rules governing the securities markets and the commodities markets because those markets are inextricably linked, even though there are significant differences between types of investments involved in each market. *Id.* The comment to section 9-115 gives an example:

> Suppose, for example, that a firm has a position in a securities market that is hedged by a position in a commodity market, so that payments that the firm is obligated to make with respect to the securities position will be covered by the receipt of funds from the commodity position. Depending upon the settlement cycles of the different markets, it is possible that the firm could find itself in a position where it is obligated to make the payment with respect to the securities position before it receives the matching funds from the commodity position. If cross-margining arrangements have not been developed between the two markets, the firm may need to borrow funds temporarily to make the earlier payment. The Section 9-115 rules would facilitate the use of positions in one market as collateral for loans needed to cover obligation in the other market.

Id.

2. *Creation and attachment*

A security interest in investment property, like a security interest in other types of collateral, may be created under section 9-203 by signing a security agreement.[278] Section 9-115(3) gives special clarification of the requirements for description of investment property collateral in a security agreement (or financing statement).[279]

Under section 9-203(1), a security interest in investment property, however, may also be created, even without a security agreement, if the secured party obtains control of the invest-

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[278] *Id.* § 9-203(1).

[279] *Id.* § 9-115(3). Clarification in section 9-115(3) provides as follows:

> A description of collateral in a security agreement or financing statement is sufficient to create or perfect a security interest in a certificated security, uncertificated security, security entitlement, securities account, commodity contract, or commodity account whether it describes the collateral by those terms, or as investment property, or by description of the underlying security, financial asset, or commodity contract. A description of investment property collateral in a security agreement or financing statement is sufficient if it identifies the collateral by specific listing, by category, by quantity, by a computational or allocational formula or procedure, or by any other method, if the identity of the collateral is objectively determinable.

Id. § 9-115(3). Descriptions will also be subject to the liberalizing provisions of section 9-110 providing that "any description of personal property . . . is sufficient whether or not it is specific if it reasonably identifies what is described." *Id.* § 9-110.

One writer illustrates the need for these clarifying and liberalizing provisions in light of the new and complex terminology of Revised Article 8:

> For example, presume that debtor A holds all of her investments, including stock in *ABC* Corporation, in account #123 at brokerage firm *B*. She signs a security agreement purporting to grant a security interest in "all of the securities owned by debtor." . . . [R]ead literally, this description may not include, and the security interest may not attach with respect to, the securities entitlements owned by the debtor because the debtor may not be deemed to own the securities "held" in this account for [Revised] Article 8 and 9 purposes. [Section 9-115(3)] recognizes that, regardless of the technical legal characterization, people do, and probably will continue to, speak as though they owned the securities held indirectly through the account. Consequently, this technically incorrect language will be deemed a sufficient description of the securities entitlements.

Schroeder, *supra* note 3, at 379.

ment property. In the case of a certificated security, section 9-115(6) adds a special rule that creates and perfects a security interest when the secured party takes possession of the certificate, even where the secured party has neither a security agreement nor the endorsements necessary to obtain control.[280]

Section 9-116 contains special automatic attachment rules to provide certainty and promote liquidity in the settlement process.[281] Under section 9-116(1), a securities intermediary that credits a financial asset to the purchaser's securities account before receiving full payment for the financial asset from the purchaser automatically has a perfected security interest in such financial asset.[282] No agreement or other action is required for attachment or perfection.[283] Under section 8-106(e), an intermediary is deemed to have control of any interest in a security entitlement granted to the intermediary by the entitlement holder, so the intermediary would have control in this automatically created security interest for all priority and adverse claim cut-off purposes in Articles 8 and 9.

3. Perfection

Under section 9-115(4), a security interest in investment property is perfected if the secured party has control.[284] A se-

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[280] U.C.C. § 9-115(6) (1996). This security interest has priority over other non-control security interests, but does not benefit from the adverse claim cut-off provisions triggered by obtaining control. *Id.; see also id.* § 9-115 cmt. 2.

[281] *See id.* § 9-116 cmt. 1.

[282] *Id.* § 9-116(1). "This is a codification and adaptation to the indirect holding system of the so-called 'broker's lien,' which has long been recognized in existing law." *Id.* § 9-116 cmt. 2. Section 9-116(2) applies a similar automatic attachment rule to any person making delivery before receiving payment for a certificated security (or other financial asset represented by a writing) pursuant to an agreement between persons in the business of dealing in such financial assets. *Id.* § 9-116(2).

[283] *See id.* § 9-116(1) (stating "[a] security agreement is not required for attachment or enforceability of the security interest, and the security interest is automatically perfected.") The same is true for the automatically attached security interest under section 9-116(2). *Id.* § 9-116(2).

[284] *Id.* § 9-115(4)(a). As previously noted, a secured party in possession of a security certificate in registered form that does not have the necessary endorsements to obtain control also has a perfected security interest in such security. *Id.*

cured party who does not have control may also perfect a security interest by filing a financing statement.[285] Any secured party with control will have priority over a non-control secured party regardless of the time of filing or perfection.[286] Therefore, filing with respect to investment property has very different effects than filing with respect to other types of collateral. Perfection by filing is new to the securities markets; there was no provision for it under prior law. Lenders in the securities markets have not historically searched for previous filings when taking securities as collateral. The revisions to Article 9 add filing as an alternative means of perfection, but it is not the preferred mechanism and is trumped in all cases by control.[287]

As previously noted, a securities intermediary that credits a financial asset to the purchaser's securities account before receiving full payment for the financial asset from the purchaser automatically has a perfected security interest in such financial asset. Since an intermediary is deemed to have control of any interest in a security entitlement granted to the intermediary under section 8-106(e), this automatic perfection rule is really just an application of the perfection-by-control rule.

An additional automatic perfection rule applies to security interests in investment property granted by securities intermediaries. Section 9-115(4)(c) provides that "[i]f the debtor is a broker or securities intermediary, a security interest in investment property is perfected when it attaches."[288] This automatic perfection rule eliminates the need for filing by a non-control secured lender to a securities intermediary. In fact, section 9-115(4)(c) goes on to provide that "[t]he filing of a financing statement with respect to a security interest in investment

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§ 9-115(6). Such a security interest has priority over all conflicting, non-control security interests, but the secured party has none of the adverse claim cut-off protection resulting from control. *Id.* § 9-115(6).

[285] U.C.C. § 9-115(4)(b) (1996).

[286] *Id.* § 9-115(5)(a).

[287] *Id.* § 9-115 cmt. 5.

[288] *Id.* § 9-115(4)(c). A parallel, automatic perfection rule for security interests in commodity contracts or accounts granted by a commodity intermediary is set forth in section 9-115(4)(d). *Id.* § 9-115(4)(d).

property granted by a broker or securities intermediary has no effect for purposes of perfection or priority with respect to that security interest."[289] Secured lenders to securities firms may require that the investment property collateral be credited to the lender's own account up front (a so-called "hard pledge"), or may permit the borrowing firm to retain the investment property subject to a promise that it will be transferred to the secured party's account on demand (a so-called "agreement to pledge" or "AP" arrangement).[290] Under the revisions to Articles 8 and 9, the hard-pledge lender has control and, consequently, has a perfected interest.[291] The AP lender automatically perfects under section 9-115(4)(c), but does not have control. Under previous law, AP lenders had an automatically perfected security interest for a period of twenty-one days from attachment without filing or possession, but in order to continue the perfected interest for subsequent periods new value had to be given.[292] This led to the practice of rolling over AP secured loans at least every twenty-one days.[293] Under new section 9-115(4)(c), there is no time limit on the automatic perfection rule and no need for the technical formality of rolling over loans.[294]

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[289] *Id.* § 9-115(4)(c). There is a parallel provision with respect to secured lending to commodity intermediaries in section 9-115(4)(d). *Id.* § 9-115(4)(d).

[290] U.C.C. § 9-115 cmt. 6 (1996). The Official comment provides that:

> In some circumstances lenders may require that the transactions be structured as "hard pledges," where the securities are transferred on the books of a clearing corporation from the debtor's account to the lender's account or to a special pledge account for the lender where they cannot be disposed of without the specific consent of the lender. In other circumstances, lenders are content with so-called "agreement to pledge" or "agreement to deliver" arrangements, where the debtor retains the positions in its own account, but reflects on its books that the positions have been hypothecated and promises that the securities will be transferred to the secured party's account on demand.

Id.

[291] *Id.* § 9-115 cmt. 6.

[292] *See* U.C.C. § 8-313 cmt. 3 (1978).

[293] *See* U.C.C. § 9-115 cmt. 6 (1996).

[294] U.C.C. § 9-115 cmt. 6 (1996).

4. Priority

Under section 9-115(5), security interests of a secured party with control have priority over security interests of secured parties without control.[295] Conflicting security interests among secured parties with control rank equally.[296] Time sequence of perfection and awareness of conflicting interests are irrelevant.[297] The only exception to the equal ranking of secured parties with control is that "a security interest in a security entitlement or securities account granted to the debtor's own securities intermediary has priority over any security interest granted by the debtor to another secured party," unless the intermediary agrees otherwise.[298] An external secured lender with control through a three-party control agreement would therefore have to include a subordination provision in such agreement in order to be ranked on a par or above the debtor's intermediary.[299]

A security interest created under section 9-115(6) (for the benefit of a secured party in possession of a security certificate without the endorsements necessary for control) has priority over all other security interests perfected by means other than control.[300]

Conflicting security interests granted by a securities intermediary that are automatically perfected without control under the automatic perfection rule in section 9-115(4)(c) all rank equally among themselves but would be subordinated to any conflicting security interest of a secured party with control.[301]

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[295] *Id.* § 9-115(5)(a).

[296] *Id.* § 9-115(5)(b).

[297] *Id.* § 9-115 cmt. 5.

[298] *Id.* §§ 9-115(5)(b)-(c). A parallel priority rule is set forth in section 9-115(5)(d) for security interests in commodity contracts or accounts granted to the debtor's own commodity intermediary. *Id.* § 9-115(5)(d).

[299] U.C.C. § 9-115 cmt. 5 (1996). The mere agreement of the intermediary to act on entitlement orders that are originated by the external secured party does not constitute an agreement to subordinate the intermediary's security interest. *See id.* § 9-115 cmt. 5 (Example 5).

[300] *Id.* § 9-115(6).

[301] *Id.* § 9-115(5)(e). With respect to a security interest granted by a securities intermediary, filing a financing statement has no effect for purposes of perfection or priority. Therefore, there are no perfected, non-control security interests grant-

Conflicting security interests in all other cases (*i.e.*, those perfected by filing) are governed by the normal first-in-time priority rules of section 9-312(5), (6), and (7).[302] The special priority in section 9-312(4) for purchase money security interests in other types of collateral is inapplicable to investment property because the basic control priority rule in section 9-115(5) already gives primacy to intermediaries in the ordinary cases in which investment property is purchased on margin or other credit.[303]

IV. CONCLUSION: THE BENEFITS OF REVISED ARTICLE 8

There are few areas of commercial law in which national uniformity is more essential than the law governing the basic clearance and settlement of our public securities markets. In that regard, conformity to a new Article 8 being adopted throughout the country was a practical inevitability in this state. That Mississippi was among the first half of the states to study and put this complex revision into place speaks well of the forces supporting business and commercial law reform in the state.

Revised Article 8, however, brings benefits to Mississippi investors, issuers, and securities intermediaries beyond simply being up-to-date and uniform with the rest of the country. All investors, issuers, and intermediaries benefit when the law better fits and describes commercial reality. Revised Article 8 makes substantial progress in this direction not only by dealing directly with the indirect holding system, but by doing so in such a way (*e.g.*, (1) maintaining neutrality on direct versus indirect holding and certificated versus uncertificated securities and (2) favoring private-ordering standards over public-ordering rigidity) that flexibility remains for evolution in market structures and mechanisms. On the most general level, such an improvement cannot help but increase certainty and lessen systemic risk in the markets. This should enhance market

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ed by securities intermediaries *other* than those automatically perfected under section 9-115(4)(c). *Id.* § 9-115(4)(c).

[302] *Id.* § 9-115(5)(f).

[303] *See id.* § 9-115 cmt. 5.

liquidity, efficiency, and continuity which benefit everyone.

With these general benefits come a number of incremental, concrete improvements. For investors, the property rights and claims of those holding in the indirect system are more clear as are the baseline duties of their intermediaries.[304] Revised Article 8 adds flexible new means of perfecting security interests and clarifies their effects, which should enhance availability of secured financing not only from intermediaries but also from external sources.[305] For issuers, the burden of transaction statements and registered pledge programs have been eliminated,[306] and potential liability for transfer to adverse third-party claimants has been reduced.[307]

For intermediaries, Revised Article 8 establishes that duties in the indirect holding system run only to an intermediary's own customers and may be appropriately shaped to fit market reality by agreement, subject to the objective standards of good faith.[308] To the extent that law at this basic property and commercial level can do so, it improves the legal environment for secured financing at both the retail and the wholesale levels of intermediary operation by formally instituting the super-priority of the intermediary lender.[309] Revised Article 8 clarifies the priority of hard-pledge lenders over entitlement holders in the event of shortfall at the debtor intermediary,[310] improves the automatic perfection rules for AP lenders by eliminating the need for formalistic but costly roll-overs every twenty-one days,[311] and adds new means of perfecting security interests and clarifying their effects[312] and improving choice of law rules.[313]

Some critics have questioned facets of the Revised Article 8 rules and have suggested that some of the new provisions,

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[304] *See supra* notes 174-225 and accompanying text.
[305] *See supra* notes 278-87 and accompanying text.
[306] *See supra* notes 140-53 and accompanying text.
[307] *See supra* notes 160-69 and accompanying text.
[308] *See supra* notes 174-225 and accompanying text.
[309] *See supra* notes 288-92 and accompanying text.
[310] *See supra* notes 189-96 and accompanying text.
[311] *See supra* notes 281-87 and accompanying text.
[312] *See supra* notes 278-87 and accompanying text.
[313] *See supra* notes 86-91 and accompanying text.

viewed in isolation, disfavor individual investors or should do more to protect consumers.[314] Proponents of Revised Article 8 have responded that such provisions should not be viewed in isolation[315] and that consumer protection, if needed, should be provided by other bodies of law in the complex mosaic overlaying the public markets.[316] In the face of this response, even

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[314] For critical analyses of Revised Articles 8's provisions, see Mark G. Lake & Henry Bregstein, *Fraudulent Pledge of Securities of Nonpublic Corporations: The Inadequacy of U.C.C. Article 8,* 112 BANKING L.J. 958 (1995) (suggesting additional provisions that would protect secured creditor from subsequent issuances by closely held corporation controlled by debtor that would dilute value of original collateral); Egon Guttman, *U.C.C. D.O.A.: Le Roi Est Mort, Vive le Roi,* 26 LOY. L.A. L. REV. 625 (1993) (critique of U.C.C. reform efforts generally, including Revised Article 8, as too focused on needs of commercial participants and insufficiently focused on non-industry, consumer-type needs); Schroeder, *supra* note 3 (in-depth analysis of Revised Article 8 provisions); Note, *Super-Priority of Securities Intermediaries under the New Section 9-115(5)(c) of the Uniform Commercial Code,* 108 HARV. L. REV. 1937 (1995) (outlining legal and policy arguments for and against super-priority provision).

[315] Rogers, *Policy Perspectives, supra* note 3, at 1497. A recurring theme in Professor Rogers's policy exegesis of Revised Article 8 is that "one cannot decide whether a given rule is good or bad for investors merely by asking whether it imposes liability on intermediaries or exonerates intermediaries from liability. . . ." *Id.* Such rules must be put in the overall context of a market in which the vast majority of transactions do not result in claims or problems and in which the efficient operation of intermediaries benefits all. As Professor Rogers puts it:

> Here, as in so many issues within the limited scope of Article 8, we are not dealing with a matter on which the interests of providers of financial services and users of financial services diverge. More liability for intermediaries does not mean more protection for investors. Quite the contrary, the sole reason for the rule exonerating intermediaries from liability is to ensure that intermediaries will perform the functions that customers wish them to perform.

Id. at 1540-41.

Professor Rogers outlines a policy defense, from the individual investor point of view, of some of the more controversial provisions of Revised Article 8 (including the adverse claim limitation provisions of section 8-115, the intermediary transferee claim cut-off provisions of section 8-511 and the super-priority provisions of section 9-115), in Rogers, *Policy Perspectives, supra* note 3, at 1493-1545.

[316] Rogers, *Policy Perspectives, supra* note 3, at 1540-42. As Professor Rogers asserts:

> Thus, it simply misses the point to suggest, as does some recent commentary, that although Revised Article 8 does a good job of modernizing the law for the complexities of the clearance and settlement system, it may not do enough to protect the interests of individual inves-

critics have concluded that Revised Article 8 is a success at what it sets out to do and an important step forward.[317]

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tors. Revised Article 8 does not distinguish between individual versus institutional investors, between rich investors or poor investors, between long-term investors and speculators, between investors and traders, or any other such categories. There is no correlation between the Revised Article 8 term "entitlement holders" and any such typology. Nor can the relationship between "entitlement holder" and "securities intermediaries" be translated into "customer/consumers/individual investors" and "brokers." In this respect, Revised Article 8 is just like the real estate recording acts — it protects the title of purchasers generally, without drawing distinctions among the class of purchasers. The real estate recording acts proceed on the entirely sensible basis that protecting security of title is a good thing for everyone, including those who buy, sell, or own real estate as well as those who are professionally engaged in arranging real estate transactions. The general answer to the question of whether Revised Article 8 is beneficial or adverse to the interests of individual securities investors is exactly the same. The main thing that Revised Article 8 does is adapt to the modern indirect holding system, and state in simple and clear terms, rules that provide security of title to purchasers of investment securities who hold through intermediaries in much the same fashion that negotiability concepts provided security of title for the paper-based securities markets of a previous era or that real estate recording acts provide for the real estate markets.

There are, to be sure, some areas of commercial law in which it may make sense to deal separately with transactions affecting individual natural persons and those affecting business entities; but Article 8 is not such a topic.

Id. at 1540-51.

[317] One of the most thorough studies of Revised Article 8, after holding numerous aspects up to a critical light, concludes that:

> [Revised Article 8 is] a bold attempt to rethink the law of conveyancing of investments in securities and other forms of financial assets. By looking at the practices of the securities market with a fresh eye rather than assuming without question traditionalist notions of how property is conveyed, the drafters were remarkably successful in freeing themselves from the physical metaphor and ostensible ownership fallacy which haunt property law generally, and commercial law, specifically. The drafting committee which is currently considering more general revisions to Article 9 should continue the process started in [Revised Article 8] in order to bring commercial law out of the nineteenth century and into the twenty-first where non-physical property relations with respect to intangible assets will certainly dominate our economy.

Schroeder, *supra* note 3, at 502.

MODERNIZING COMMERCIAL FINANCING PRACTICES: THE REVISIONS TO ARTICLE 5 OF THE MISSISSIPPI UCC

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I. INTRODUCTION

The Uniform Commercial Code (UCC) is in the midst of a comprehensive overhaul. Every article of the UCC, save one, either has been revised recently or will be in the near future.[1] The Mississippi legislature, with the advice of the office of the Secretary of State, has been quick to consider and adopt changes to the UCC[2] drafted by the National Conference of Commissioners on Uniform State Laws (NCCUSL) and the American Law Institute (ALI).[3] One section of the UCC that

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[1] Jean Braucher, *The UCC Gets Another Rewrite*, A.B.A. J., Oct. 1996, at 66, 66. The exception is article 7, which deals with warehouse receipts, bills of lading, and other documents of title. U.C.C. § 7-101 (1977).

[2] *See, e.g.*, Bryn R. Vaaler, *Revised Article 8 of the Mississippi UCC: Dealing Directly with Indirect Holding*, 66 MISS. L. J. 249 (1997).

[3] UNIFORM COMMERCIAL CODE REVISED ARTICLE 5. LETTERS OF CREDIT (WITH CONFORMING AND MISCELLANEOUS AMENDMENTS TO ARTICLES 1, 2, AND 9) (PROPOSED FINAL DRAFT), *reprinted in* UNIF. COMMERCIAL CODE 2B U.L.A. 100-136 (Supp. 1996) [hereinafter LETTERS OF CREDIT]. In this article, I refer to the re-

ALI and NCCUSL have reworked extensively is Article 5, governing letters of credit.[4] On April 2, 1996, Governor Kirk Fordice signed House Bill 1139 making Revised Article 5 a part of Mississippi's version of the Uniform Commercial Code.[5]

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vised version of Article 5 enacted by the Mississippi Legislature as "Revised Article 5" and the superseded version of Article 5 as "Article 5." I refer to specific provisions of Revised Article 5 as "Revised § __." With very minor exceptions not germane to this article, revised Article 5 drafted by ALI and NCCUSL and the Revised Article 5 enacted in Mississippi are identical. *Compare* MISS. CODE ANN. §§ 75-5-101 to -117 (Supp. 1996) (containing Mississippi's version of Revised Article 5), *with* UNIF. COMMERCIAL CODE §§ 5-101 to -117, 2B U.L.A. 107-133 (Supp. 1996) (containing newly revised version of Article 5).

[4] LETTERS OF CREDIT, *supra* note 3, at xv, *reprinted in* 2B U.L.A. at 101 (Supp. 1996). The American Bar Association's UCC Committee began the revision process with the appointment of a Task Force composed of practitioners and academics. *Id.* The Task Force reviewed current practices and law regarding letters of credit and after much deliberation, recommended appropriate revisions to Article 5. *Id.* An ALI/NCCUSL drafting committee was appointed, and used the Task Force report as a starting point for its deliberations. *Id.* at xvii-xviii. A number of observers and advisers representing the banking community, government agencies, and letter of credit users were invited to participate in the drafting process. *Id.* The drafting committee met nine times for drafting sessions and published the drafts in *The Business Lawyer* and *The Letter of Credit Update*. LETTERS OF CREDIT, *supra* note 3, at xviii, *reprinted in* 2B U.L.A. at 102 (Supp. 1996). Finally, the draft revisions were debated and approved by NCCUSL and ALI. *Id.* As of September 1996, fourteen states have adopted Revised Article 5: Alaska, California, Colorado, Conecticutt, Hawaii, Idaho, Illinois, Indiana, Iowa, Kansas, Mississippi, Nebraska, Oklahoma, and West Virginia. LETTER OF CREDIT UPDATE, Sept. 1996, at 11.

[5] 1996 Miss. Laws 460. Revised Article 5 became effective in Mississippi July 1, 1996. MISS. CODE ANN. § 75-5-101 (Supp. 1996). Mississippi's version of the UCC is found in Chapters 1 through 10 of Title 75 of the Mississippi Code. MISS. CODE ANN. § 75-1-101 (1972). Revised Article 5 has received some recent scholarly attention. *See, e.g.*, James G. Barnes, *Internationalization of Revised UCC Article 5 (Letters of Credit)*, 16 NW. J. INT'L L. & BUS. 215 (1995); James G. Barnes & James E. Byrne, *Letters of Credit: 1995 Cases*, 51 BUS. LAW. 1417 (1996); James E. Byrne, *The Revision of UCC Article 5: A Strategy for Success*, 56 BROOK. L. REV. 13 (1990); James E. Byrne, *Revised UCC Section 5-108(e): A Constitutional Nudge to Courts*, 29 UCC L.J. 419 (1997); Joseph D. Gustavus, *Letter of Credit Compliance Under Revised UCC Article 5 and UCP 500*, 114 BANKING L.J. 55 (1997); George A. Hisert, *Uniform Commercial Code: Does One Size Fit All?*, 28 LOY. L.A. L. REV. 219 (1994); Boris Kozolchyk, *Strict Compliance and the Reasonable Document Checker*, 56 BROOK. L. REV. 45 (1990); Gerald T. McLaughlin, *Should Deferred Payment Letters of Credit Be Specifically Treated in a Revision of Article 5?*, 56 BROOK. L. REV. 149 (1990); Margaret L. Moses, *The Impact of Revised Article 5 on Small and Mid-Sized Exporters*, 29 UCC L.J. 390

Letters of credit are financing devices developed to fill specific financing niches in the commercial marketplace, particularly in international trade.[6] Normally a letter of credit transaction involves at least three parties.[7] For example, assume a Mississippi cotton broker receives a shipment order for cotton from a clothing manufacturer in Nicaragua. If the Mississippi business has not had dealings with the Nicaraguan company, the business might be uneasy about the prospects for getting paid once the cotton leaves the United States. If reliable information concerning the creditworthiness of the Nicaraguan company is difficult to find, the Mississippi broker may be reluctant to ship the cotton. Thus, a potentially lucrative deal that may have lead to a fruitful, continuing relationship could fail to materialize. The letter of credit historically emerged to facilitate precisely this type of transaction.[8]

Article 5 is a short chapter in the UCC that has generated, relative to other UCC chapters, few decisions by Mississippi's federal and state courts. Mississippi's experience in this regard is not unique.[9] One reason for this paucity of

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(1997); Carlyle C. Ring, *Jr., Key UCC Changes on Letters of Credit are in the Works*, 13 BANKING POL'Y REP. 7 (1994); Milton R. Schroeder, *The 1995 Revisions to UCC Article 5, Letters of Credit*, 29 UCC L.J. 331 (1997); James J. White, *The Influence of International Practice on the Revision of Article 5 of the UCC*, 16 NW. J. INT'L L. & BUS. 189 (1995); *An Examination of U.C.C. Article 5 (Letters of Credit)*, 45 BUS. LAW. 1521 (1990); Katherine A. Barski, Comment, *Letters of Credit: A Comparison of Article 5 of the Uniform Commercial Code and the Uniform Customs and Practice for Documentary Credits*, 41 LOY. L. REV. 735 (1996).

[6] JOHN F. DOLAN, THE LAW OF LETTERS OF CREDIT ¶ 1.01 (rev. ed. 1996).

[7] *Id.* Revised Article 5 allows for two-party letters of credit. Revised § 5-102(a)(10). Also, a letter of credit transaction might involve several intermediary financial institutions. These types of transactions are discussed *infra*.

[8] It is important to note that letters of credit are only one of many bank-issued devices which are used to ensure performance. For example, a bid bond is a guarantee established in connection with international construction bids. BLACK'S LAW DICTIONARY 162 (6th ed. 1990). It ensures that the contract will be executed if awarded. A performance bond is similar to a bid bond, but guarantees payment of a certain amount if performance under a contract is deficient. BLACK'S LAW DICTIONARY 1138 (6th ed. 1990). This article will only examine letters of credit.

[9] *An Examination of U.C.C. Article 5 (Letters of Credit)*, 45 BUS. LAW. 1521, 1532 (1990) [hereinafter *Examination*]. However, the number of reported cases has increased over time. Differences in "usage, practice, players, and pressure" have

litigation is the flexibility Article 5 has traditionally given the parties to a letter of credit transaction in structuring their relationship and enforcing their agreements.[10] However, given technological changes that have revolutionized commercial practice over the past several decades, Article 5 had to be "modernized."[11]

Moreover, from the time of its initial drafting, Article 5 ignored international customs and practices[12] regarding let-

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led to a large increase in litigation under Article 5. *Id.* "Indeed, the approximately sixty-two cases reported in the United States in 1987 constituted double the cumulative reported cases up to 1965." *Id.*

[10] A few provisions of Article 5 have been the subject of much litigation. The best example is probably the "independence principle" found in Revised Article 5 § 103(d). For a discussion of the "independence principle" see *infra* notes 51-67 and accompanying text.

[11] *Examination*, *supra* note 9, at 1532.

> [A]lmost forty years of hard use have revealed weaknesses, gaps, and errors in the original statute which compromise its relevance. U.C.C. Article 5 was one of the few areas of the Uniform Commercial Code which did not benefit from prior codification and it should come as no surprise that it may require some revision.

Id.

[12] Parties to letters of credit often incorporate the Uniform Customs and Practices, or "UCP" as terms of the letters of credit. INT'L CHAMBER OF COMMERCE, PUB. NO. 500, ICC UNIFORM CUSTOMS AND PRACTICE FOR DOCUMENTARY CREDITS (1993) [hereinafter UCP 500]. The UCP is a set of rules of conduct embodied in a code of practice which has achieved broad acceptance by parties engaged in international commerce. *Id.* The UCP does not have the character of law, but due to its widespread use, it often carries the force of law. *Id.*

The UCP was created by, and is updated by, the International Chamber of Commerce's (ICC) Commission on Banking Technique and Practice. ICC FACTSHEET: HISTORY OF THE INTERNATIONAL CHAMBER OF COMMERCE (June 1995). The ICC was founded in 1919 "to serve world business by promoting trade and investment, open markets for goods and services, and the free flow of capital." *Id.* The ICC's members include thousands of businesses located in 140 countries. ICC FACTSHEET: MEMBERSHIP (June 1995). The ICC has top-level consultative status with the United Nations where it puts forward the views of businesses in industrialized and developing countries. ICC FACTSHEET: THE WORLD BUSINESS ORGANIZATION (June 1995). It also maintains close relations with other international organizations. *Id.* The current version of the UCP is contained in ICC Publication No. 500, which was released in 1993. Copies of this document and other ICC publications are available through ICC Publishing, Inc., 156 Fifth Avenue Suite 308, New York, NY 10010, (212)206-1150.

According to Article 1 of the UCP, the UCP rules only apply where they are

ters of credit.[13] This gap led the New York legislature to "eviscerate" Article 5 by making its provisions subject to standards of trade and practice observed in the international marketplace.[14] By the late 1980's, it became apparent that the commercial marketplace increasingly would ignore Article 5 as antiquated. Even worse, Article 5 might become an impediment to legitimate, modern commercial practice.[15] Because

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explicitly incorporated by the terms of a letter of credit. See Roy Goode, *Abstract Payment Undertakings and the Rules of the International Chamber of Commerce*, 39 ST. LOUIS U. L.J. 725, 728 (1995) (citing UCP 500, art. 1). However, parties to letters of credit transactions often incorporate the UCP contractually without referring to it in the text of the letter of credit itself. *Id.* Also, courts often invoke the UCP rules by finding that they have been adopted by course of dealing or performance, or as usage of trade. *Id.* In *AMF Head Sports Wear, Inc., v. Ray Scott's All-American Sports Club, Inc.*, for example, the UCP was not specified in the underlying purchase-sale contract or the credit itself. AMF Head Sports Wear, Inc. v. Ray Scott's All-American Sports Club, Inc., 448 F. Supp. 222, 224 (D. Ariz. 1978). Relying on UCC § 5-109 comment 1 and UCC § 1-205(2), the court found the UCP was incorporated into the contract as a written trade code. *Id.*

In addition to the UCP, the United Nations Commission on International Trade Law ("UNCITRAL") is expected to adopt the U.N. Convention of International Guaranty Letters and Standby Letters of Credit (the "Convention") and submit it to the General Assembly in the near future. Barski, *supra* note 5, at 736 n.2. For a discussion of the Convention, see Eric E. Bergsten, *A New Regime for International Independent Guarantees and Stand-By Letters of Credit: The UNCITRAL Draft Convention on Guaranty Letters*, 27 INT'L LAW. 859 (1993).

[13] Dolan, *supra* note 6, ¶ 4.03[7].

> Letters of Credit are a major instrument in international trade, as well as domestic transactions. To facilitate its usefulness and competitiveness, it is essential that U.S. law be in harmony with international rules and practices, as well as flexible enough to accommodate changes in technology and practices that have, and are, evolving. Not only should the rules be consistent within the United States, but they need to be substantively and procedurally consistent with international practices.

LETTERS OF CREDIT, *supra* note 3, at xvi-xvii, *reprinted in* 2B U.L.A. at 102 (Supp. 1996).

[14] N.Y. U.C.C. LAW § 5-102(4) (McKinney Supp. 1997). New York City banks and the New York Clearing House Association urged the New York legislature to include a provision keeping attributes of the UPC. *Id.* § 5-102 N.Y. Commission Comment (1991).

[15] As the Official Comment to Revised § 5-101 states:

> [t]he objectives of . . . revised Article 5 are best achieved:
> (1) by defining the peculiar characteristics of a letter of credit that distinguish it and the legal consequences of its use from other forms of

the guiding principle of the UCC is both to "simplify, clarify and modernize" commercial law, and to "permit the continued expansion of commercial practices through custom, usage and agreement of the parties,"[16] Article 5 was due for a facelift.

Law schools do not teach the law of letters of credit in any systematic fashion.[17] Therefore, most attorneys only have a vague idea about the nature of letters of credit, and what principles regulate their use. Part II of this article will introduce briefly the different types of letters of credit. Part III will summarize the changes contained in Revised Article 5 and why they were necessary. Part IV concludes by surveying the possible implications of Revised Article 5 for parties to letter of credit transactions.

II. LETTERS OF CREDIT

A. Letters of Credit Transactions

The solution to the Mississippi businessperson's dilemma sketched above is as ingenious as it is simple. To ensure payment, the seller requires that the buyer have a third party, generally a bank, "post" a "commercial" letter of credit. In the letter of credit, the bank promises to pay the seller once the parties meet certain specified conditions such as shipment of the goods.[18] The person on whose account the credit is issued,

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> assurance . . . and, (2) by preserving flexibility through variation by agreement in order to respond to and accommodate developments in custom and usage that are not inconsistent with the essential definitions and substantive mandates of the statute . . . . Letter of credit law should remain responsive to commercial reality and in particular to the customs and expectations of the international banking and mercantile community.

Revised § 5-101 cmt.

[16] U.C.C. §§ 1-102(2)(a), (b) (1977).

[17] If the University of Mississippi Law School is typical, letters of credit might be covered in a course on commercial paper if the professor has gotten through all the material on articles 3 and 4 of the UCC. Otherwise, letters of credit are discussed as necessary in courses such as bankruptcy law in order to understand specific issues in commercial cases.

[18] Obviously, such letters of credit play a vital role in both international trade and in domestic transactions. In 1990, an estimated $200 billion in letters of

usually a buyer of goods or services, is termed the "applicant."[19] The bank or other person that issues the credit is called the "issuer."[20] The seller who "draws" on the credit after performing is termed the "beneficiary."[21]

A typical letter of credit transaction, therefore, involves three distinct agreements: (i) the underlying purchase-sale contract between buyer and seller;[22] (ii) a contract between the bank and buyer under which the buyer promises to reimburse the bank if the bank pays under the letter of credit;[23] and (iii) an undertaking by the issuer bank by which the bank undertakes[24] to pay the seller if the seller meets certain conditions.[25] Letters of credit can be revocable or irrevocable.[26]

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credit were outstanding. *Examination*, *supra* note 9, at 1531.

[19] Revised § 5-102(a)(2).

[20] Revised § 5-102(a)(9).

[21] Revised § 5-102(a)(3).

[22] In the example discussed earlier in the text, this contract would be governed by Article 2 of the Mississippi UCC, Nicaraguan law, or perhaps the United Nations Convention on the International Sale of Goods. *See* JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE 702 (4th ed. 1995) [hereinafter WHITE & SUMMERS]. Letter of credit law has little to do with this contract and the parties always remain free to sue each other in the appropriate forum. *Id.*

[23] WHITE & SUMMERS, *supra* note 22, at 702.

> This is sometimes called the reimbursement contract, but it will usually be a security agreement as well and have attributes of a loan agreement . . . . If the bank is not confident that its applicant will reimburse it, it should not issue the letter of credit, for it would be making a loan to its own customer that may not be repaid.

Id. at 702-03.

[24] *Id.* at 702.

> This undertaking in the letter of credit is sometimes called a contract, but most letter of credit specialists prefer to refer to it only as a letter of credit or as an 'undertaking' and not a contract . . . . [t]he letter of credit is a unilateral undertaking with no promise by anyone, other than the bank.

Id.

[25] Bank of Cochin Ltd. v. Manufacturers Hanover Trust Co., 612 F. Supp. 1533, 1537 (S.D.N.Y. 1985), *aff'd*, 808 F.2d 209 (2d Cir. 1986). The traditional view in the United States has been that letter of credit law requires a beneficiary to strictly adhere to such conditions. *Id.*

[26] Revised § 5-106(a). Unlike the pre-revision code, under Revised Article 5 a letter of credit is presumed to be irrevocable unless it specifically provides otherwise. *Id.*

As letters of credit have gained currency as financing devices, users have adapted them to different commercial transactions. As a result, others, besides the applicant, issuer, and beneficiary, can be parties to a letter of credit transaction. For example, a transaction might involve another institution or individual who is a "confirmer."[27] The confirmer is also obligated to pay on the credit once the appropriate documentation is presented. In a situation where an American bank is issuing a letter of credit in favor of a foreign seller, the foreign seller might insist on having a confirmer in its own country. This allows the seller to choose a bank in its home country. The seller will likely be more familiar with the creditworthiness of a bank in its own country than the creditworthiness of an American bank. Before agreeing to be a confirmer, the foreign bank obviously would investigate the American bank's creditworthiness to ensure the American bank would indeed pay when presented with the letter of credit.[28]

The transaction might also involve an adviser, who has no obligation to pay on the letter of credit. The adviser merely acts as a conduit for documents and information passing between the issuer and beneficiary. For instance, an American issuer might employ a foreign adviser bank to inform a foreign beneficiary that the American bank issued a letter of credit in the beneficiary's favor.[29] Banks normally issue letters of cred-

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[27] Revised § 5-102(a)(4). A confirmer is defined as a "nominated person who undertakes, at the request or with the consent of the issuer, to honor a presentation under a letter of credit issued by another." *Id.* A nominated person is "a person whom the issuer (i) designates or authorizes to pay, accept, negotiate, or otherwise give value under a letter of credit and (ii) undertakes by agreement or custom and practice to reimburse." *Id.* § 5-102(a)(11).

[28] NATIONAL CONFERENCE OF COMMISSIONER'S ON UNIFORM STATE LAWS, UNIFORM COMMERCIAL CODE REVISED ARTICLE 5. LETTERS OF CREDIT — A SUMMARY 1 (1995). Banks that regularly post letters of credit in connection with international trade develop relationships over time with banks in other countries which obviate the need for thorough credit checks in each transaction. *Id.* at 2.

[29] *Id.* at 2. Revised Article 5 defines an adviser as "a person who, at the request of the issuer, a confirmer, or another adviser, notifies or requests another adviser to notify the beneficiary that a letter of credit has been issued, confirmed, or amended." Revised § 5-102(a)(1). The UCP 500 states: "[a] Credit may be ad-

it in exchange for a fee paid by the buyer. These fees vary depending on the type of credit and the creditworthiness of the applicant.[30] The payment of the fee is the consideration for the bank's promise to pay the seller under terms of the letter of credit.[31] In deciding whether or not to post the letter of credit and what fee to charge for its services, the bank/issuer determines the creditworthiness of the buyer, who is often a regular customer of the bank. Thus, at each stage of the transaction the party best able to assess the risk of nonpayment does so. In this fashion, the parties presumably minimize the anxiety and risk attendant to dealing with distant parties unknown to each other. Typically, the credit is honored only after the seller produces documents verifying the buyer's receipt or control of conforming goods.[32]

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vised to a Beneficiary through another bank (the 'Advising Bank') without engagement on the part of the Advising Bank, but that bank, if it elects to advise the Credit, shall take reasonable care to check the apparent authenticity of the Credit . . . ." UCP 500 art. 7 (1993).

[30] Exxon v. Banque de Paris et des Pays-Bas, 828 F.2d 1121, 1122 (5th Cir. 1987), *vacated on other grounds*, 488 U.S. 920 (1988). In *Exxon*, a fee of $53,000 was charged for the issuance of a $19.53 million letter of credit (about .27% of the total amount of the credit). *Exxon*, 828 F.2d at 1122: *see also In re* Compton Corp., 831 F.2d 586, 589 (5th Cir. 1987) (involving .25% fee on $585,444 letter of credit). *But see* Dibrell Bros. Int'l S.A. v. Banca Nazionale Del Lavoro, 38 F.3d 1571, 1575 (11th Cir. 1994) (involving 1.5% fee on $4 million credit). In addition to charging a fee, banks might also obtain a security interest in the buyer's property in order to ensure repayment should it be necessary to honor the credit. *In re* Slamans, 69 F.3d 468, 476 n.6 (10th Cir. 1995).

[31] Revised § 5-108(g). Under Revised Article 5, all terms and conditions must be documentary. *Id.* See discussion *infra* note 122 and accompanying text.

[32] CHARLES DEL BUSTO, ICC GUIDE TO DOCUMENTARY CREDIT OPERATIONS FOR THE UCP 500 21-22 (1994). There are three methods by which payment is collected under a letter of credit arrangement: 1) "Documentary collection" allows the seller to receive payment only upon presentation of certain delivery documents and a draft on the buyer. *Id.* at 21. 2) "Clean collection" is an arrangement which requires only that the seller draw a draft on the buyer for the value buyer has given. *Id.* A draft is an order to pay a payee made by one party, the drawer, to another party, the drawee. *See* U.C.C. §§ 3-104(a), (e) (1995) (defining negotiable instruments). Typically, he then presents the draft to his bank (the Remitting Bank), which sends the draft along with a collection letter to a correspondent bank (the collecting bank) which is usually in the same city as the buyer. DEL BUSTO, *supra*, at 21-22. 3) Under a "direct collection" arrangement, the seller typically obtains his bank's pre-numbered direct collection letter [which enables]

B. VARIETIES OF LETTERS OF CREDIT

1. Commercial Letters of Credit

A "commercial letter of credit" is the type of letter of credit described above.[33] The success or failure of performance by the beneficiary, normally the purchaser of goods, does not determine the right to payment under commercial letters of credit. To draw on the commercial letter of credit, the beneficiary only needs to present specified commercial documents required by the terms of the letter of credit. Besides the draft, such documents might consist of, among others, warehouse receipts, shipping documents, insurance certificates, or inspection receipts. If the documents presented are those required by the letter of credit, the issuer must pay, despite the buyer's insolvency or inability to perform the underlying contract between the parties.[34]

2. Standby Letters of Credit

"Standby letters of credit" are a relatively recent development in commercial finance.[35] A standby letter of credit func-

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him to send documents directly to his bank's correspondent bank for collection. This kind of collection makes the paperwork process more efficient. *Id.* at 22.

[33] *See* California Health Facilities Auth. v. Commissioner, 90 T.C. 832, 839-40 (1988) (describing commercial credit practices). Similar to a commercial credit, a "direct pay" letter of credit is intended to be a conduit for payment. *Id.* However, direct pay credits do not involve normal commercial buy-sale contracts and are not honored on presentation of third-party documents. Michael Stern, Comment, *The Independence Rule In Standby Letters of Credit*, 52 U. CHI. L. REV. 218, 219 n.14 (1985). "A high percentage of . . . credit[s] backing commercial paper . . . are . . . [direct pay letters of credit.]" John E. Rogers, *Mexican Corporate Banking in a North American Market*, 2 NO. 9 MEX. TRADE & L. REP. 9, 20 n.15 (1992). Additionally, direct pay credits often protect the beneficiary from a "preference attack" (i.e. from having to return payments to the issuer) in the event that the issuer files for bankruptcy. Id.; *see also* 11 U.S.C. § 547 (1994) (describing avoidance of preferential transfers by trustee in Bankruptcy).

[34] WHITE & SUMMERS, *supra* note 22, at 702.

[35] LETTERS OF CREDIT, *supra* note 3, at xv, *reprinted in* 2B U.L.A. at 101 (Supp. 1996)

> When the original Article 5 was drafted 40 years ago, it was written for paper transactions and before many innovations in letters of credit. Now electronic and other media are used extensively. Since the

tions as a guarantee of payment. The issuer undertakes to pay under the letter of credit only if the applicant defaults.[36] To collect on a standby credit, the beneficiary must present non-commercial documents, such as an affidavit indicating that

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> 50's, standby letters of credit have developed and now nearly $500 billion standby letters of credit are issued annually worldwide, of which $250 billion are issued in the United States.

Id.

[36] Henry D. Gabriel, *Standby Letters of Credit: Does the Risk Outweigh the Benefits?*, 1988 COLUM. BUS. L. REV. 705, 709-10. Standby letters of credit differ from commercial letters of credit in that under a standby letter of credit the rights of the beneficiary are triggered "only after the customer has defaulted on the underlying contract." *Id.* In addition to standby letters of credit, there are other forms of guaranty which insure beneficiaries against non-performance. Numerous statutory provisions regulate these devices. *See e.g.*, MISS. CODE ANN. §§ 87-5-1 to -13 (1972) (regulating principal and surety devices); MISS. CODE ANN. §§ 31-5-3 to -57 (1972 & Supp. 1996) (regulating bonds in public works contracts). Also, the American Law Institute publishes a restatement of the law of suretyship which, incidentally, does not address letter of credit transactions. RESTATEMENT (THIRD) OF SURETYSHIP AND GUARANTY § 4(2) (1996). Guaranty devices are frequently utilized in the construction industry.

> A "bid bond" is a promise by a contractor, which is guaranteed by a surety company, to indemnify the owner against loss resulting from the refusal of the contractor, upon awarding of the contract, to enter into the contract. A "payment bond" is a promise by a contractor, which is guaranteed by a surety company, that the said contractors and materialmen who supply services and material for the construction of the project, will be paid by the contractor.

L.F. Pace & Sons, Inc. v. Travelers Indem. Co., 514 A.2d 766, 768 n.2 (Conn. App. Ct. 1986). *See generally* Mississippi State Bldg. Comm'n v. Becknell Constr., Inc., 329 So. 2d 57, 59 (Miss. 1976) (involving suit brought by State Building Commission against construction company for bid bond forfeiture); Morgan v. United States Fidelity & Guar. Co., 191 So. 2d 917, 919 (Miss. 1966) (involving suit by surety against construction company to enforce indemnity agreement).

The case of *U.R.S. Co., Inc. v. Gulfport-Biloxi Regional Airport Authority* illustrates many of the legal principles which govern performance bond transactions. U.R.S. Co. v. Gulfport-Biloxi Reg'l Airport Auth., 544 So. 2d 824, 826 (Miss. 1989). Insurance Company of North America (INA) was surety for McDaniel Brothers Construction Company (McDaniel), the prime contractor in the construction of an airport terminal. *U.R.S.*, 544 So. 2d at 825. McDaniel improperly installed the roof of the terminal and when it began to leak, the roof had to be replaced. *Id.* INA was liable for this amount. *Id.* However, the court determined that McDaniel would have installed the roof correctly had the architect properly inspected the roof and informed McDaniel of the necessary alterations. *Id.* at 827. Thus, INA was entitled to indemnity from the architect. *Id.* at 828.

the buyer is in default.[37] The bank that issues a standby letter of credit must investigate more than the applicant's ability to perform under the reimbursement agreement. The issuer likely will require information and assurances regarding the ability of the applicant to meet its obligations in the underlying transaction without default.[38] Standby letters of credit are often used to secure performance of large construction contracts or bond agreements. Bankers often cannot assess accurately the risk of default in such situations. Therefore, the issuer should view a standby letter of credit as a business loan to the applicant, similar to a business line of credit. Standby letters of credit may be secured by including a pledge of collateral in the reimbursement agreement between the issuer and the applicant.[39] As two leading commentators note, "[u]nlike commercial letters, almost all standbys expire without a draw and with no payment. When there is a draw on a typical standby letter of credit, something has gone awry."[40]

3. Red Clause Letters of Credit

A "red clause" letter of credit contains a provision allowing the confirming bank or another named bank to make advances to the beneficiary before presentation of the documents. Beneficiaries, such as middlemen and dealers, who require a form of prefinancing, often demand this type of credit. If the beneficiary takes an advance but later fails to present the required documents, the applicant becomes responsible

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[37] *Exxon*, 828 F.2d at 1122. Federal bank regulations define a standby letter of credit as:

> any letter of credit, or similar arrangement, that represents an obligation to the beneficiary on the part of the issuer: (1) To repay money borrowed by or advanced to or for the account of the account party [applicant]; (2) To make payment on account of any indebtedness undertaken by the account party; or (3) To make payment on account of any default by the account party in the performance of an obligation.

12 C.F.R. § 32.2(p) (1996).

[38] WHITE & SUMMERS, *supra* note 22, at 703.

[39] *Id.*

[40] *Id.*

for repayment of the advances and any related cost.[41]

4. *Revolving Letters of Credit*

In contrast to conventional letters of credit, which are exhausted once applicants draft the amount of the credit, a revolving letter of credit provides renewable credit. Revolving letters of credit are increased or extended based on the passage of time or the value drawn on the credit. This type of credit is used in transactions that involve periodic drafts, or in series of transactions involving a single letter of credit.[42]

5. *Back-to-back Letters of Credit*

Sometimes sellers who are beneficiaries of a letter of credit might wish to use the credit as collateral to obtain financing.[43] Under a back-to-back arrangement, the benefits of an irrevocable credit (the "primary credit") are available to a third-party lender. To obtain a back-to-back credit, the primary beneficiary applies to a second issuing bank and submits its original credit to support the issuance of the second credit. The second bank then issues the back-to-back credit in favor

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[41] DEL BUSTO, *supra* note 32, at 49. The clause is included at the request of the applicant, who usually dictates its terms. *Id.* This type of credit is so-called because the clause was originally written in red ink to draw attention to the credit's unique nature. *Id.*; *see* Oelbermann v. National City Bank, 79 F.2d 534, 535 (2d Cir. 1935) (describing Red Clause authorizing advances to beneficiary without delivery of documents).

[42] *See, e.g.,* Trans-Global Alloy Ltd. v. First Nat'l Bank, 583 So. 2d 443, 445 (La. 1991) (requiring buyer to post $190,000 irrevocable, revolving letter of credit which would automatically be restored to original amount fifteen days after each shipment). Revolving credits are sometimes "cumulative", in which case, any sum not utilized during the first period carries over to subsequent periods. DEL BUSTO, *supra* note 32, at 48. If the credit revolves in relation to value, the credit is renewed upon utilization within a given overall period of validity. *Id.* Reinstatement might also depend on presentation of certain documents. *Id.*

[43] *See, e.g.*, Union Planters Nat'l Bank v. World Energy Sys. Assocs., 816 F.2d 1092, 1095 (6th Cir. 1987) (holding beneficiaries of letter of credit are able to assign their rights prior to performance of conditions of credit); Emery-Waterhouse Co. v. Rhode Island Hosp. Trust Nat'l Bank, 757 F.2d 399, 401 (1st Cir. 1985) (discussing that sellers also use letter of credit to guarantee payment of debt).

of the second beneficiary.[44]

6. *Two-Party Letters of Credit*

Under a "two-party" letter of credit transaction, the buyer and seller do not bring in a third party to act as a surety. In such a transaction, the applicant and the issuer are one and the same. Nonetheless, two-party letters of credit do act to ensure payment, since by entering into such an arrangement the applicant-issuer effectively waives most defenses to the underlying contract that the credit supports.[45]

III. ARTICLE FIVE

A. *Background*

The original version of Article 5 was drafted more than forty years ago at a time when domestic paper transactions predominated and only about $500 million in letters of credit were outstanding in the United States.[46] In the interim, not only has the volume of transactions increased, but the nature of the typical transaction has changed as well. Now parties annually issue approximately $250 billion in United States letters of credit.[47] The growth in international trade and the development of "just-in-time"[48] inventory systems has in-

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[44] DEL BUSTO, *supra* note 32, at 61.

[45] Revised § 5-102(10). Revised Article 5 only allows for two-party credits where the issuer is a financial institution. *Id.* Under Revised Article 5, consumers are never allowed to become "issuers" of letters of credit, otherwise creditors might use a letter of credit in consumer transactions in which the consumer would be the issuer and the creditor the beneficiary. Such a transaction would leave the consumer without defenses against the creditor and would violate the policy behind the Federal Trade Commission Rule in 16 C.F.R. § 433. Revised § 5-102 cmt. 5.

[46] Charles M.R. Vethan, *The Sacred Cow of Equity and Strict Compliance in Letter of Credit Law: Recent Trends and Projections*, 6-SPG INT'L LEGAL PERSP. 45, 46 (1994). Evidence of safe usage and participant confidence have led to an increase in the number of letter of credit transactions. *Id.* at 45-46.

[47] LETTERS OF CREDIT, *supra* note 3, at xv, *reprinted in* 2B U.L.A. at 101 (Supp. 1996).

[48] R. David Whitaker, *Letters of Credit and Electronic Commerce*, 31 IDAHO L. REV. 699, 700 (1995). Just-in-time (JIT) systems allow manufacturers to reduce

creased the need for electronic transactions. Also, this growth has led to an evolution of international commercial customs and practices relating to letters of credit.[49] These modern developments, along with court decisions which have resulted in conflicting rules, exposed the need for revision of Article 5.[50]

B. Revised Article 5

1. The Independence Principle

"The key to the uniqueness of a letter of credit and to its commercial vitality is that the promise by the issuer is independent of any underlying contracts."[51] The independence principle holds that if the beneficiary has complied with the terms of the letter of credit, the issuer must honor the credit *independent* of whether the beneficiary has met its contractual obligations to the applicant.[52]

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inventories of raw materials and components. *Id.* at 701. Under a JIT system, the purchaser and vendor enter into detailed agreements whereby deliveries are precisely timed so that they arrive just before they are processed. *Id.* at 700 n.3. One consequence of JIT systems is an increased need for speed and efficiency in communication of trade data. *Id.* at 702.

[49] LETTERS OF CREDIT, *supra* note 3, at xv, *reprinted in* 2B U.L.A. at 101 (Supp. 1996). The evolving customs and practice for letters of credit are, to a great degree, reflected in the UCP, which is updated every ten years by the ICC. *Id.*

[50] *Id.* The goals of the revision drafters were: 1) to conform Article 5 to current customs and practices: 2) to provide rules that allow for changes in customs and practices, and evolving technology; 3) to ensure that letters of credit facilitate trade; and 4) to resolve conflicts among reported decisions. *Id.* at xvii.

[51] Pringle-Associated Mortgage Corp. v. Southern Nat'l Bank, 571 F.2d 871, 874 (5th Cir. 1978). A leading hornbook describes the independence principle as the "most unique and mysterious part of the letter of credit transaction." WHITE & SUMMERS, *supra* note 22, at 703; *see* Chase Manhattan Bank v. Equibank, 550 F.2d 882, 886 (3d Cir. 1977) (stating issuer of letter of credit must pay beneficiary if terms are met); Barclays Bank D.C.O. v. Mercantile Nat'l Bank, 481 F.2d 1224, 1238-39 (5th Cir. 1973) (declaring relationship between issuer and extender of credit as well as relationship between bank and extender independent of underlying contract between issuer and beneficiary).

[52] WHITE & SUMMERS, *supra* note 22, at 703. The issuer might not be obligated to honor the credit where the applicant has filed for bankruptcy. *In re* Twist Cap, Inc., 1 B.R. 284, 285-86 (Bankr. D. Fla. 1979). Another court enjoined payment in order to mitigate the possibility that payment would jeopardize the prospects of the applicant's successful reorganization. Wysko Inv. Co. v. Great Am.

For example, with the Mississippi cotton broker and the Nicaraguan manufacturer, assume that the manufacturer arranges for a Mississippi bank to post a letter of credit for the benefit of the cotton broker. Further assume that the letter of credit is payable upon presentation of certain documents to the bank. If the cotton broker presents the proper documents to the bank, the independence principle requires the bank to pay under the letter of credit, without any further inquiry into the underlying transaction. The bank's obligation to pay does not depend on the cotton broker's shipment of the goods to the manufacturer. Instead the bank's obligation depends on whether the proper documents have been presented to the bank. The banker is "not obligated, and indeed is foreclosed from . . . going into the field to determine whether the underlying contract has been performed."[53]

Courts strictly follow the independence principle.[54] As an illustration of the independence principle, consider *Pringle-Associated Mortgage Corp. v. Southern National Bank of Hattiesburg, Mississippi*.[55] Applying the independence principle, the court held that amendment of an underlying purchase-sale contract does not affect the obligations of the issuer unless the credit itself is altered.[56] Also the beneficiary's noncompliance with the underlying contract does not affect the issuer's liability unless the letter of credit is express.[57] Due to the indepen-

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Bank, 131 B.R. 146, 148 (D. Ariz. 1991).

[53] WHITE & SUMMERS, *supra* note 22, at 703. Note, there are important, but limited exceptions to the independence principle. *Id.*

[54] *Pringle-Associated Mortgage Corp.*, 571 F.2d at 874. A recent Mississippi case established the converse of the *Pringle* holding: to wit, changes in the terms of the letter of credit do not modify the underlying contracts, unless the process leading up to the amendment of the letter of credit and/or the amended letter itself establishes that the parties intended to amend the underlying contract as well as the letter of credit. Mygsa, S.A. DE C.V. v. Howard Indus., 879 F. Supp. 624, 628 (S.D. Miss. 1995).

[55] 571 F.2d 871 (5th Cir. 1978).

[56] *Pringle-Associated Mortgage Corp.*, 571 F.2d at 874-75. A letter of credit's construction must not be varied simply because of the unusual nature in which it is used. *Id.*

[57] *Id.* at 874. "The purpose of the letter of credit itself . . . is to assure payment of money." *Id.*

dence principle, inconsistencies between the underlying contract and the letter of credit will not render the credit ambiguous and thus susceptible to court interpretation.

For example, in *Exxon Company, U.S.A. v. Banque de Paris et des Pays-Bas*,[58] the applicant, Houston Oil & Refining, Inc., contracted to deliver crude oil to Exxon. No exact timetable for delivery was set. The contract specified only that the deliveries were to be made during the September-December period of 1981.[59] As required by the contract, Houston Oil acquired a standby letter of credit in Exxon's favor. However, the letter of credit had an expiration date of October 31, 1981.[60] Exxon was aware that the expiration date left it with considerable exposure, since the letter of credit could expire before any default by Houston Oil. Nonetheless, after reviewing the letter of credit Exxon failed to disapprove it.[61] Houston Oil made no deliveries before the expiration date.[62] Two days after expiration, Houston Oil informed Exxon that it would default.

Exxon then presented the letter to the issuer, Banque de Paris et des Pays-Bas, also known as Banque Paribas. After Banque Paribas refused to honor the expired letter of credit, Exxon sued for wrongful dishonor.[63] The Federal District Court found the discrepancy between the expiry date and allowable performance dates should be resolved by interpreting the letter of credit against its author, Banque Paribas.[64] The Fifth Circuit, applying the independence principle, found that

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[58] 828 F.2d 1121 (5th Cir. 1987).

[59] *Exxon*, 828 F.2d at 1122. Exxon entered this contract because it had a surplus of crude oil on hand. *Id.*

[60] *Id.* at 1122-23. Since the expiration date fell on a Saturday, the documents could also be presented on Monday, November 2, the next business day. *Id.* at 1123.

[61] *Id.* at 1123. The court noted that Exxon was an experienced trader of crude oil and had the transaction papers examined by its employees. *Id.*

[62] *Id.* Before the expiration date Exxon was informed of the problems surrounding the expiration date and Exxon's exposure. *Id.*

[63] *Id.* at 1122-24. In this case Exxon demanded payment after the expiration date and sued the bank for failure to pay. *Id.* at 1122.

[64] *Exxon*, 828 F.2d at 1124. The district court in effect extended the expiration date without defining it. *Id.*

the inconsistent contract did not render the credit ambiguous and entered judgment for Banque Paribus.[65]

Revised § 5-103(d) states the independence principle as follows:

> Rights and obligations of an issuer to a beneficiary or a nominated person under a letter of credit are independent of the existence, performance, or nonperformance of a contract or arrangement out of which the letter of credit arises or which underlies it, including contracts or arrangements between the issuer and the applicant and between the applicant and the beneficiary.[66]

Courts should strictly follow the independence principle, because, as the drafters of Article 5 note,

> [o]nly staunch recognition of this principle by the issuers and the courts will give letters of credit the continuing vitality that arises from certainty and speed of payment under letters of credit. To that end, it is important that the law not carry into letter of credit transactions rules that properly apply only to *secondary* guarantees or to other forms of engagement.[67]

2. Strict Construction

Given that the independence principle requires payment of a letter of credit if the parties comply with the letter of credit's terms, it is not surprising that courts strictly construe the terms of letters of credit. The issuer does not have to pay the beneficiary unless the beneficiary precisely meets the terms.[68] Thus, the beneficiary must ensure the terms of the letter of credit are clearly expressed and consistent with the underlying contract.

In the case of *In re Coral Petroleum, Inc.*,[69] Coral applied

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[65] *Id.* at 1126. The court held that the letter of credit required no construction other than the express language it contained. *Id.*

[66] Revised § 5-103(d).

[67] Revised § 5-103 cmt. 1 (emphasis in the original).

[68] *Exxon*, 828 F.2d at 1124. "A letter of credit is . . . strictly construed." *Id.*

[69] 878 F.2d 830 (5th Cir. 1989).

for credit in favor of Tradax Petroleum American, Inc. The terms of the letter of credit contained an internal inconsistency. To collect on the letter of credit, the terms required Tradax to present documentation showing it had *delivered* a shipment of sweet crude to Coral and it had *transferred* a shipment of sour crude to Coral.[70] The issuer, French American Banking Corp. (FABC) prepared the letter exactly according to Coral's instructions. Tradax then reviewed the letter of credit and approved it, without noticing the inconsistency. The underlying contract actually called for Tradex to deliver sweet crude.

After Tradax had performed under the contract, Coral filed for chapter 11 bankruptcy without paying for the shipment. Tradax attempted to collect on the letter of credit. Since Tradax was unable to present the inconsistent documentation that the letter required, FABC refused to make payment. Tradax then sought reformation of the letter of credit in the bankruptcy court.[71] In affirming the bankruptcy court, the Fifth Circuit refused to reform the letter of credit despite the internal inconsistency, stating, "[a] beneficiary who negligently inspects a letter of credit and thereby fails to discover that the requirements are impossible for him to satisfy should be required to 'pay the piper'. . . . "[72]

Revised section 5-108(a) adopts the strict compliance standard:

> [A]n issuer shall honor a presentation that, as determined by the standard practice referred to in subsection (e), appears on its face strictly to comply with the terms and conditions of the letter of credit. Except as otherwise provided in [Article 5] and unless otherwise agreed with the applicant, an issuer shall dishonor a presentation that does not appear so to comply.[73]

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[70] *Coral*, 878 F.2d at 831-33.

[71] *Id.*

[72] *Id.* at 833; *see* East Girard Sav. Ass'n v. Citizens Nat'l Bank & Trust Co., 593 F.2d 598, 602 (5th Cir. 1979) (finding existence of entitlement to payment "independent of collateral obligations which may exist under other underlying contracts").

[73] Revised § 5-108(a).

Despite the absolute language of Revised section 5-108(a), the drafters note that strict compliance does not require "slavish conformity to the terms of the letter of credit."[74] Instead, the drafters endorse the conclusion of the court in *New Braunfels National Bank v. Odiorne*.[75] In that case, the court held that a beneficiary could collect under a letter of credit although the draft requested payment on "Letter of Credit No. 86-122-5" and the letter of credit specified "Letter of Credit No. 86-122-S."[76] The court reasoned that strict compliance does not require oppressive perfectionism.[77] Thus, Revised Article 5 seems to adopt a standard best characterized as strict, but not slavish,[78] construction.[79]

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[74] *Id.* § 5-108 cmt. 1.

[75] 780 S.W.2d 313 (Tex. Ct. App. 1989).

[76] *New Braunfels*, 780 S.W.2d at 318.

[77] *Id.*; *see* American Airlines, Inc. v. F.D.I.C., 610 F. Supp. 199, 202 (D. Kan. 1985) (allowing consideration of letter of credit and other documents together to establish compliance); Temple-Eastex, Inc. v. Addison Bank, 672 S.W.2d 793, 796 (Tex. 1984) (holding accompanying documents may be considered in determining if beneficiary has strictly complied with terms of letter of credit).

[78] Revised § 5-108 cmt. 1. The drafters explicitly reject, however, a less rigorous "substantial compliance" standard that was arguably applied in seminal Article 5 cases. *Id.*; *see* Flagship Cruises, Ltd. v. New England Merchants Nat'l Bank, 569 F.2d 699, 703 (1st Cir. 1978) (trying to find balance between strict compliance and substantial compliance); Banco Espanol de Credito v. State St. Bank & Trust Co., 385 F.2d 230, 237 (1st Cir. 1967) (missing statement that draft was drawn in conjunction with letter of credit did not in itself justify bank's refusal to pay).

[79] Revised § 5-108 cmt. 1. This result might also flow from Revised section 5-108(e), which is incorporated into Revised section 5-108(a), and provides that "[a]n issuer shall observe standard practice of financial institutions that regularly issue letters of credit. Determination of the issuer's observance of the standard practice is a matter of interpretation for the court. The court shall offer the parties a reasonable opportunity to present evidence of the standard practice." *Id.* § 5-108(e).

The Official Comment 8 to Revised § 5-108 indicates that the "standard practice" referenced by § 108(e) may be (i) international practice such as the UCP, (ii) other practices published by financial institutions, or (iii) local and regional practice. Where practices conflict, the parties should indicate which practices govern their agreement. *Id.* § 5-108 cmt. 8. However, when there is a direct conflict between standard practice under Revised Article 5 and the UCP, the standards reflected in Revised Article 5 apply absent some express agreement or course of dealing to the contrary. *Id.* § 5-116(c). For a detailed discussion and comparison

Finally, under Revised Article 5, issuers have a reasonable time in which to honor the credit, or to give notice to the presenter of discrepancies in the presentation.[80] Unless otherwise provided, the period is not to exceed seven business days.[81]

3. *Incorporating Rules of Custom or Practice*

Beyond the UCC provisions regarding letters of credit, Revised Article 5 specifically permits the incorporation of other rules of custom or practice. For example, parties to letter of credit transactions often agree to apply the rules contained in the UCP.[82] If the parties expressly make a letter of credit subject to the UCP, Revised section 5-116(c) provides that the agreement varies the provisions of Article 5 with which the UCP conflicts.[83] Only the non variable provisions in Revised

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of the letter of credit compliance standards in Revised Article 5 and the UCP, see generally Gustavus, *supra* note 5.

Another source for standard banking principles is the forthcoming publication of the United States Council on International Banking ("USCIB") called the "White Book." Gustavus, *supra* note 5, at 56. The White Book is essentially a distillation of internal banking checklists prepared by member banks of the USCIB, which number approximately 450. *Id.* The USCIB's members also produce similar rules through regional and district committees. *Id.*

[80] Revised § 5-109(b). Failure to give notice or to mention fraud, forgery, or expiration in the notice does not preclude the issuer from asserting fraud or forgery as a basis for dishonor where a required document is forged or materially fraudulent, or honor of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant. *Id.* § 5-108(d). In deciding whether to honor a credit, the issuer is required to observe standard practice of financial institutions that regularly issue letters of credit." *Id.* § 5-108(e). Whether such practices have been followed is a matter for interpretation by the court. *Id.*

Revised § 5-108(e) has generated some scholarly debate concerning whether or not the right to jury trial guaranteed by the Seventh Amendment is abrogated by leaving the regarding standard practices to the court. *Compare Moses, supra* note 5 (arguing Revised § 5-108(e) abridges the Seventh Amendment right to jury trial) *with Byrne, supra* note 5 (arguing revision was intended to leave such decisions to courts where permissible under Seventh Amendment).

[81] Revised § 5-108(b). This provision conforms the U.C.C. with UCP art. 7(b) (1993). *Id.* § 5-108 cmt. 3.

[82] For a description of the UCP, see *supra* note 12. Indeed, the popularity of the UCP even in the face of conflicting provisions of the Article 5 was a major motivating factor in the revision process. *See, e.g.*, Revised § 5-108 cmt. 3.

[83] Revised § 5-116(c). A detailed discussion of the provisions of the UCP is beyond the scope of this article. For a comparison between the UCP and Revised

section 5-103(c) are excepted.[84]

Moreover, the revisions to Article 5 harmonize many provisions with those of the UCP 500.[85] However, the UCP contains many detailed provisions covering subjects not specifically covered in Revised Article 5.[86]

4. Definition of Letter of Credit

Revised Article 5 defines a "letter of credit"[87] as "a definite undertaking" evidenced by an authenticated record and created by the issuer, in favor of a beneficiary, at the request or for the account of an applicant.[88] Thus, an essential element of a letter of credit is a direct promise by the issuer to

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Article 5, see generally Barski, *supra* note 5.

[84] Revised section 5-116(c) provides: "Except as otherwise provided in this subsection, the liability of an issuer, nominated person, or adviser is governed by any rules of custom or practice, such as the Uniform Customs and Practice for Documentary Credits, to which the letter of credit, confirmation, or other undertaking is expressly made subject." Revised § 5-116(c).

[85] For instance, Revised section 5-108(b) and UCP article 13(b) each provide a reasonable time, not to exceed seven business days, in which the issuer is to examine documents and give the beneficiary notice of any discrepancies. The UCP and Revised Article 5 provide that letters of credit are irrevocable unless they state otherwise. Revised § 5-106(a); UCP art. 6(c). Revised section 5-102(a)(10) and UCP article 2 allow for two-party letters of credit. Revised § 5-102(a)(10); UCP art. 2.

[86] The UCP, unlike Revised Article 5, has provisions dealing with forces majeure (Art. 17), bank-to-bank reimbursement arrangements (Art. 19), marine/ocean bills of lading (Art. 23), and insurance documents (Art. 34). U.C.P. arts. 17, 19, 23, 34.

[87] The UCP defines a letter of credit as:

> [A]ny arrangement, however named or described, whereby a bank (the "Issuing Bank") acting at the request and on the instructions of a customer (the "Applicant") or on its own behalf, (i) is to make a payment to or to the order of a third party (the "Beneficiary"), or is to accept and pay bills of exchange (Draft(s)) drawn by the Beneficiary, or (ii) authorizes another bank to effect such payment, or to accept and pay such bills of exchange (Draft(s)), or (iii) authorizes another bank to negotiate, against stipulated document(s), provided that the terms and conditions of the Credit are complied with.

Id. art. 1.

[88] Revised §§ 5-102(a)(10), 5-104. Revised section 5-102(a)(10) also provides for so-called "two-party" letters of credit, which are discussed *infra*.

pay the addressee (beneficiary) of the letter once certain conditions are met.

In *Hendry Construction Company, Inc. v. Bank of Hattiesburg*,[89] Hendry Construction attempted to obtain a loan from Deposit Guaranty National Bank (DGNB).[90] While processing the loan, DGNB sent a letter addressed to Hendry Construction's president advising him that DGNB was processing the loan and DGNB would approve it, subject to certain conditions.[91] Hendry Construction then delivered the letter to the Bank of Hattiesburg (the Bank) trying to obtain a short-term construction loan.

The Bank received the letter along with the loan application.[92] The Bank lent Hendry Construction $138,543 but refused further advances. Hendry sued the Bank alleging that its acceptance of the $800,000 "letter of credit" to ensure repayment evidenced the Bank's commitment to make further advances.[93] In reversing and rendering judgment in favor of the Bank, the court noted that the letter sent to Hendry Construction by DGNB, which was not addressed to the Bank (the alleged beneficiary), did not constitute a "letter of credit."[94]

Moreover, under Article 5, a letter of credit had to be in writing and signed by the issuer.[95] Revised section 5-104 provides that "letter[s] of credit, confirmation[s], advice[s], transfer[s], amendment[s], or cancellation[s], may be issued in any form that is a record and is authenticated."[96] The authentication may be either "(i) by a signature or (ii) in accordance with the agreement of the parties[97] or the standard practice."[98]

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[89] 562 So. 2d 100 (Miss. 1990).

[90] *Hendry*, 562 So. 2d at 101.

[91] *Id.* at 102.

[92] *Id.* at 101

[93] *Id.* at 101, 102.

[94] *Id.* at 102.

[95] U.C.C. § 5-104(1) (1991). Additionally, under Article 5 a telegram could be a letter of credit if it identified the sender by an authorized authentication. *Id.* § 5-104(2).

[96] Revised § 5-104. A "record" is "information that is inscribed on a tangible medium, or that is stored in an electronic or other medium and is retrievable in perceivable form". *Id.* § 5-102(a)(14).

[97] *Id.* § 5-104. Course of dealing and usage of trade will also give particular

This provision makes the UCC more compatible with modern commercial practice.

In international transactions, parties sometimes electronically transmit letters of credit that they then print at the advising bank and provide to the beneficiary as an original document. By not specifying any particular medium for transmission of the letter of credit, there is room for further development in commercial practice. Modern methods of electronic transmission make possible secure transmission of such documents, thus allaying concerns regarding tampering with the terms of the document.[99]

5. Injunctive Relief

Letters of credit are of little practical value if courts can enjoin payment under a letter of credit because of defenses based on the underlying transaction, such as a claim of fraud. To make it more difficult for an applicant to secure an injunction and stop the issuer from honoring a presentation based on a claim of fraud, Revised Article 5 requires the fraud be material.[100] Revised Article 5 also requires that the fraud be either by the beneficiary on the issuer or applicant, or that a required document be forged or materially fraudulent.[101]

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meaning to and supplement or qualify the terms of the agreement to the extent provided by U.C.C. § 1-205. U.C.C. § 1-205 (1991). Thus, any system rules that might apply because the information is transmitted by a particular means will influence the agreement. R. David Whitaker, *Letters of Credit and Electronic Commerce*, 31 IDAHO L. REV. 699, 711 (1995).

[98] Revised § 5-104. Revised section 5-108(e) requires that issuers observe standard practices of financial institutions that regularly issue letters of credit. *Id.* § 5-108(e). Compliance is a matter for interpretation by the court. *Id.*

[99] *Id.* § 5-108(e).

[100] *Id.* § 5-109(a). The scope of the "materiality" requirement is left to courts to define. The comments to Revised section 5-109 use the example of the presentation of documents indicating compliance with a contract for the delivery of 1000 gallons of salad oil. If 998 gallons are shipped, the two gallon shortfall probably would not constitute a "material breach." On the other hand, if the contract were for the delivery of five gallons, a two gallon discrepancy likely would be "material." *Id.* § 5-109 cmt. 1.

[101] Revised § 5-109 cmt. 1. "[T]he fraudulent aspect of a document [must] be material to a purchaser of that document or . . . the fraudulent act [must] be

Besides defining the substantive requirements for enjoining a letter of credit, Revised Article 5 establishes a high standard for injunctive relief. A court may enjoin the honoring of a letter of credit where it finds (1) the applicable law does not prohibit an injunction; (2) parties whom the injunction may harm are adequately protected against loss that may result from the injunction; (3) state-law conditions for the granting of an injunction are met; and (4) the applicant is likely to succeed in its fraud claim, and the beneficiary is not entitled to protection as a good faith purchaser for value.[102]

6. Remedies and Statute of Limitations

If an issuer repudiates or wrongfully dishonors a letter of credit, the beneficiary is entitled to recover the amount subject to repudiation or wrongful dishonor plus incidental damages, interest and attorney fees.[103] Reasonable attorney fees and other expenses of litigation must be awarded to the prevailing party.[104] "Damages may be liquidated, but only if the amount or formula is reasonable in light of the harm anticipated."[105] If the issuer's obligation is not for the payment of money,[106] besides recovering incidental damages, interest and attorney fees, the beneficiary has the option of obtaining specific performance or recovering an amount equal to the value of

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significant to the participants in the underlying transaction." *Id.*

[102] *Id.* §§ 5-109(b)(1)-(4). An injunction shall not be issued if honor of the presentation is demanded by: (i) a nominated person who has given value in good faith and without notice of [the] forgery or material fraud; (ii) a confirmer who has in good faith honored the credit; (iii) a holder in due course of a draft drawn under [the credit] which was taken after acceptance by the issuer or nominated person, or (iv) an assignee of the issuer's or nominated person's deferred obligation that was taken for value and without notice of forgery or material fraud after the obligation was incurred by the issuer or nominated person. *Id.* §§ 5-109(b)(4), 5-109(a)(1).

[103] *Id.* §§ 5-111(a), (d).

[104] *Id.* § 5-111(e).

[105] *Id.* § 5-111(f).

[106] Revised § 5-111(f). Revised section 5-101(a)(10) provides for the creation of non-monetary letters of credit that may be honored by "delivery of an item of value." *Id.* § 5-101(a)(10).

performance.[107] Finally, applicants may also recover incidental damages, interest and attorney fees resulting from the wrongful honoring or dishonoring of a letter of credit."[108]

To satisfy the statute of limitations in an action to enforce a right or obligation arising under Revised Article 5, an aggrieved party must commence an action within one year after the expiration date of the relevant letter of credit or one year after the claim accrues, whichever occurs later.[109] The claim accrues when the breach occurs, despite whether the aggrieved party knows of the breach.[110]

7. Miscellaneous Provisions of Revised Article 5

Revised Article 5 contains several additional innovations including provisions concerning warranties,[111] unstated expiry dates,[112] perpetual letters of credit,[113] successors by operation of law,[114] and rules of decision where case law is in conflict.[115] Revised Article 5 also follows the revocability rules in

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[107] *Id.* §§ 5-111(a), (c), (e).

[108] *Id.* §§ 5-111(a), (b), (d), (e).

[109] *Id.* § 5-115. UCP art. 9(a)(ii) and Revised section 5-102(a)(8)(iii) allow for deferred payment letters of credit. Thus, it is possible for the breach to occur after the expiration date. *Id.* § 102(a)(8)(iii).

[110] *Id.*

[111] Revised § 5-110(a)(1), (2). When a beneficiary's presentation is honored, the beneficiary warrants: 1) to the party to whom presentation is made, that there is no material fraud or forgery; and 2) "to the applicant that the drawing does not violate any agreement between the applicant and beneficiary or any other agreement intended by them to be augmented by the credit." *Id.* "If, for example, an underlying sales contract authorized the beneficiary to draw only upon 'due performance' and the beneficiary drew even though it had breached the . . . contract by delivering defective goods, honor of its draw would breach the warranty." *Id.* § 5-110 cmt. 2. The warranties in this section are not defenses to dishonor by the issuer or to non-reimbursement by the applicant. *Id.* § 5-110 cmt. 1.

[112] *Id.* § 5-106(c). Under Revised section 5-106(c), if there is no expiration date or other provision determining a letter's duration, it "expires one year after its stated date of issuance or, if none is stated, after the date on which it is issued." *Id.*

[113] *Id.* § 5-106(d). Under Revised section 5-106(d), if a credit states that it is perpetual, it "expires five years after its stated date of issuance, or if none is stated, after the date on which it is issued." *Id.*

[114] *Id.* §§ 5-102(a)(15), 5-113.

[115] *See* Revised §§ 5-106 cmt. 1 (noting adoption of judicial decisions as to irre-

the UCP for letters of credit that do not indicate whether they are revocable or irrevocable.[116]

Under Revised Article 5, parties to a letter of credit transaction may choose which jurisdiction's law will govern the arrangement. "The jurisdiction whose law is chosen need not bear any relation to the transaction."[117] If the parties fail explicitly to provide a choice of law provision, the law of the jurisdiction in which the liable party is located governs liability.[118]

All terms and conditions of the letter of credit must be "documentary," meaning that the letter of credit can only be conditioned on the performance of conditions relating to the presentation of documents that the issuer can examine quickly for compliance. Nondocumentary terms and conditions, such as a provision "prohibiting 'shipment on vessels more than fifteen years old,' are to be disregarded and treated as surplusage."[119]

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vocability of letters of credit); 5-108 cmts. 1, 3, 4, 7, 9 (discussing application and rejection of judicial interpretations); 5-109 cmts. 1, 3 (adopting judicial decisions regarding material fraud); 5-113 cmt. 1 (affirming courts' "requirements for recognition of successor's status"); 5-117 cmt. 1 (endorsing judicial requirements for subrogation).

[116] UCP Art. 6(c). "A letter of credit is revocable only if it so provides." Revised § 5-106(a).

[117] Revised § 5-116(a). This provision reflects the current practice of specifying that the law of a particular jurisdiction, such as New York, will apply to the transaction regardless of whether or not the transaction is related to the jurisdiction. *Id.* § 5-116 cmt. 1.

Perhaps as most states adopt the uniform version of Revised Article 5, this practice will decline in importance. For example, if the Mississippi businessman in the example *infra* specifies that Mississippi law would apply to the transaction, greater uniformity in state law would presumably assure that all parties would feel comfortable about what Mississippi law would provide. Moreover, the ability to bootstrap UCP provisions into a letter of credit likely will make choice of law provisions less important.

[118] *Id.* § 5-116(b).

[119] *Id.* § 5-108(g), 108 cmt. 9. The drafters make clear that nondocumentary conditions are better handled under the law of suretyship or contract. *Id.* § 5-108 cmt. 9. In requiring nondocumentary conditions to be ignored, the drafters cite with approval the Fifth Circuit's opinion in *Pringle-Associated Mortgage Corp. Id.* This provision is a response to case law inconsistencies regarding non-documentary conditions. Id. *See, e.g.*, United States v. Sun Bank, 609 F.2d 832, 833 (5th Cir. 1980) (stating obligation of issuer of letter of credit to examine documents imposes only duty to scrutinize documents required under credit); Raiffeisen-Zentralkasse Tirol v. First Nat'l Bank, 671 P.2d 1008, 1009 (Colo. Ct. App. 1983)

The revision clarifies the rights of subrogation by parties who have completed their performance in letter of credit transactions.[120] This provision removes an impediment that some courts have found to subrogation because they conclude that the issuing bank's (or other claimant's) rights are "independent" of the underlying obligation.[121] Revised section 5-114 expressly validates the beneficiary's present assignment of letter of credit proceeds if made after the credit is established but before the proceeds are realized in the transaction.[122]

IV. SUMMARY OF THE BENEFITS OF REVISED ARTICLE 5

The drafters of Revised Article 5 recognized

> [u]niform laws can be enacted only if there is a consensus that the benefits achieved advance the public interest in a manner that can be embraced by all users of the law. It ap-

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(stating UCC does not prevent inclusion of nondocumentary terms).

[120] Revised § 5-117(a). Revised section 5-117 grants only the rights that would exist if the person seeking subrogation "were a secondary obligor." A "secondary obligor" is "a surety, guarantor or other person against whom or whose property an obligee has recourse with respect to the obligation of a third party. *Id.* § 5-117 cmt. 1 (citing RESTATEMENT (THIRD) OF SURETYSHIP & GUARANTY § 1 (1995)).

[121] Tudor Dev. Group, Inc. v. United States Fidelity & Guar., 968 F.2d 357, 364 (3rd Cir. 1992). The drafters endorse the position of Judge Becker in and *Tudor Development Group, Inc. v. United States Fidelity & Guar.* Revised § 5-117 cmt. 1. In *Tudor Development Group, Inc.*, the majority concluded that "a bank that has issued a standby letter of credit may never qualify for equitable subrogation to the rights of its defaulting customer in the underlying commercial transaction." *Tudor Dev. Group Inc.*, 968 F.2d at 364 (Becker, J., dissenting). Judge Becker, dissenting, felt that the policies underlying Article 5 (such as the independence principle) did not "deny subrogation to all issuers of standby letters of credit." *Id.* at 368 (Becker, J., dissenting). Judge Becker would retain subrogation for issuers of stand by letters of credit, and apply it sparingly on a case-by-case basis. *Id.* at 369 (Becker, J., dissenting). The decision as to whether to apply subrogation in a particular case would be determined by a balancing of the equities. *Id.* at 370-71 (Becker, J., dissenting).

[122] Revised § 5-114 cmt. 1. "A beneficiary may assign its right to part or all of the proceeds of a letter of credit. The beneficiary may do so before presentation as a present assignment of its right to receive proceeds contingent upon its compliance with the terms and conditions of the letter of credit." *Id.* § 5-114(b). An issuer or nominated person "need not recognize an assignment of proceeds . . . until it consents to the assignment. *Id.* § 5-114(c). However, "consent may not be unreasonably withheld . . . ." *Id.* § 5-114(d).

> pears that as drafted, Revised Article 5 will enjoy substantial support by the participating interests in letter of credit transactions.[123]

Unsurprisingly, therefore, Revised Article 5 contains provisions beneficial to all parties to a letter of credit. Harmonizing United States law with international practice will be a boon to all parties to such transactions. Moreover, the revised code allows the issuer of a credit to subject the credit to the law of the jurisdiction that is most favorable.[124] The preclusion of consequential and punitive damages[125] should moderate the cost of issuing letters of credit. The defined statute of limitations[126] allows for more certainty in valuing potential liabilities. Allowing the parties to a credit to vary any provision of Article 5 except those few contained in section 5-103(c) provides the flexibility necessary for the parties to incorporate evolving commercial customs and practices into their letter of credit.

Because general disclaimers and waivers cannot appear within boilerplate provisions of a letter of credit, all parties should be better informed of their obligations and rights under the credit. Through the strict compliance standard, the UCC seeks to ensure appropriate performance by beneficiaries. The Revised Code makes clear that applicants will have a cause of action against beneficiaries who commit fraud or forgery or draw on the credit violating any other agreement.[127]

Through the Independence Principle the Revised Code requires issuers to evaluate promptly the documentation and decide whether they will honor the beneficiaries' presentation, thus greatly reducing the possibility of a crippling delay in honoring letters of credit. Moreover, attorney's fees, incidental damages and interest are available to beneficiaries who have had a letter of credit wrongfully rejected.[128] Finally, the Re-

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[123] LETTERS OF CREDIT, *supra* note 3, at xxi, *reprinted in* 2B U.L.A. at 103 (Supp. 1996).

[124] *See supra* note 117.

[125] *See supra* notes 103-105 and accompanying text.

[126] *See supra* notes 109-110 and accompanying text.

[127] *See supra* notes 100-101.

[128] *See supra* note 108. For an argument that the fee shifting provision in

vised Code does not require beneficiaries to mitigate damages.

V. CONCLUSION

From the above discussion, the cumulative effect of the revisions to Article 5 is to align Mississippi law with the prevailing and future national and international commercial practices and customs in letter of credit transactions. The Revised Code permits great flexibility to the parties in structuring their transactions. It also affirms the independence of letters of credit from the underlying transaction between the parties, thus strengthening the use of such credits as financing devices. Finally, Revised Article 5 clarifies previously murky areas of the law of letters of credit. Hopefully this clarification will have the salutary effect of adding certainty as well, thus reducing the cost of letter of credit transactions.

In sum, the revised Code promises to foster the expanded use of letters of credit in commercial finance, thus providing a boon to marketplace actors in Mississippi, the United States, and the world.

Revised § 5-111(e) will harm small and mid-sized exporters, *see* Moses, *supra* note 5. Professor Moses argues that small beneficiaries , as "one shot players," are generally less sophisticated, have limited exposure to litigation, and are more risk averse than issuers, who tend to be "repeat players." *Id.* at 414. Moses cites no evidence from the commercial litigation arena to support her hypothesis. On the other hand, if such beneficiaries are over deterred from bringing legitimate lawsuits because of the requirement that "loser pays" the prevailing party's attorney's fees, then Revised § 5-111(e) could be revised to make the award of fees discretionary or to award fees only to a party injured by wrongful dishonor. *Id.* at 416-18.

ETHICAL CONSIDERATIONS IN APPOINTMENT AND COMPENSATION OF AN ATTORNEY FOR A CHAPTER 11 DEBTOR-IN-POSSESSION

Robert J. Landry, III and
James R. Higdon[*]

I. INTRODUCTION

There are a panoply of parties that all come together in a chapter 11 case. The parties may include debtors,[1] trustees,[2] examiners,[3] committees of creditors or equity security hold-

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[1] 11 U.S.C. § 109(d) provides who may be a debtor under chapter 11. In most cases there is no trustee appointed, therefore the debtor remains in possession and has most of the powers of the trustee. *See* 11 U.S.C. §§ 1104, 1107 (1994). Hence, the debtor in a chapter 11 case is called a "debtor-in-possession." 11 U.S.C. § 1101(1) (1994).

Unless otherwise indicated, all citations to Title 11 are to those provisions as last amended by the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, 108 Stat. 4106 (1994), signed into law by President Clinton on October 22, 1994.

[2] A court will appoint a trustee in rare instances and only after a showing of either (1) "cause," such as fraud or gross mismanagement by the debtor-in-possession; or (2) appointment is in the interest of creditors, equity security holders and/or other interest of the estate. 11 U.S.C. § 1104(a) (1994).

[3] On the request of a party in interest after notice and hearing and if there has been no appointment of a trustee, the court may appoint an examiner. 11 U.S.C. § 1104(c) (1994). The examiner performs some of the duties of the trustee, such as investigating the financial condition and business operations of the debtor, filing a statement of findings with the court and transmitting those findings to other parties in interest. 11 U.S.C. §§ 1106(a)(3)-(4), 1106(b) (1994). The exam-

ers,[4] and of course creditors. These parties all have a palpable interest they wish to preserve and protect as much as possible in the bankruptcy proceeding. Some of the parties act on their own behalf while others act on behalf of others. Parties acting on behalf of others will usually find themselves in a fiduciary relationship.[5]

Usually, each party will have retained legal representation.[6] When an attorney is employed, he must act with total loyalty to his client as mandated by the Model Rules of Professional Conduct[7] and when an attorney is appointed under 11 U.S.C. § 327(a), he "assumes a fiduciary responsibility to refrain from rendering any unauthorized service in furtherance of an interest adverse to the client he serves by court appointment."[8] Thus, an attorney in a chapter 11 case must abide by

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iner can perform any other duties of the trustee as the court may direct. 11 U.S.C. § 1106(b).

[4] 11 U.S.C. § 1102(a)(1)-(2) (1994).

[5] A fiduciary is "[a] person having duty, created by his undertaking, to act primarily for another's benefit in matters connected with such undertaking." BLACK'S LAW DICTIONARY 625 (6th ed. 1990).

[6] The Bankruptcy Code provides that the trustee and committee may employ attorneys. 11 U.S.C. §§ 327, 1103 (1994). The debtor-in-possession is generally given the same powers as the trustee, including the power to employ counsel under 11 U.S.C. § 327. 11 U.S.C. § 1107(a) (1994).

[7] MODEL RULE OF PROFESSIONAL CONDUCT Rule 1.3 cmt. [1] (1983). The comment to the rule provides in part:

> A lawyer should pursue a matter on behalf of a client despite opposition, obstruction or personal inconvenience to the lawyer, and may take whatever lawful and ethical measures are required to vindicate a client's cause or endeavor. A lawyer should act with commitment and dedication to the interests of the client and with zeal in advocacy upon the client's behalf.

Id. See also CHARLES W. WOLFRAM, MODERN LEGAL ETHICS 146 (1986) ("The client-lawyer relationship . . . is founded on the lawyer's virtually total loyalty to the client and the client's interests.").

[8] Rome v. Braunstein, 19 F.3d 54, 62 (1st Cir. 1994) (citing Wolf v. Weinstein, 372 U.S. 633, 641 (1963)).

Even if the Bankruptcy Code did not expressly state that the attorney was in a fiduciary relationship with his client, this principle is entrenched in the law. *See* WOLFRAM, *supra* note 7, at 146. Wolfram noted:

> The entrenched lawyerly conception is that the client-lawyer relationship is the embodiment of centuries of established and stable tradition. Law-

the Bankruptcy Code's strictly enforced[9] conflict of interest restraints,[10] as well the Rules of Professional Conduct in the

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yers probably also widely assume that the relationship is unique in its fiduciary responsibilities. Such beliefs are fed by rhetoric such as the following, from Stockton v. Ford, 52 U.S. (11 How.) 232, 247 (1850):

> There are few of the business relations of life involving a higher trust and confidence than that of attorney and client, or, generally speaking, one more honorably and faithfully discharged; few more anxiously guarded by the law, or governed by sterner principles of morality and justice; and it is the duty of the court to administer them in a corresponding spirit, and to be watchful and industrious, to see that confidence thus reposed shall not be used to the detriment or prejudice of the rights of the party bestowing it.

Whatever the antiquity of the present version of the client-lawyer relationship in Anglo-American law, it is a relationship that is not unique. In legal contemplation, the designation of "fiduciary," which surely attaches to the relationship, also attaches to any relationship of principal and agent.

Id.

[9] Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (1978) (codified at 11 U.S.C. §§ 101-1330), *as amended by* Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, 98 Stat. 333 (1984) (codified as amended in various sections of 11 U.S.C. and 28 U.S.C.); Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554, 100 Stat. 3088 (1986) (codified as amended in various sections of 11 U.S.C. and 28 U.S.C.); Retiree Benefits Bankruptcy Protection Act of 1988, Pub. L. No. 100-334, 102 Stat. 610 (1988) (codified as amended in various section of 11 U.S.C.); Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, 104 Stat. 1388 (1990) (codified as amended in various sections of 11 U.S.C.); Crime Control Act of 1990, Pub. L. No. 101-647, 104 Stat. 4789 (1990) (codified as amended in various sections of 11 U.S.C. and 28 U.S.C.); Judicial Improvements Act of 1990, Pub. L. No. 101-650, 104 Stat. 5089 (1990) (codified as amended in various section of 11 U.S.C. and 28 U.S.C.); Treasury, Postal Service and General Government Appropriations Act of 1990, Pub. L. No. 101-509, 104 Stat. 1389 (1991) (codified as amended in various sections of 28 U.S.C.); Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, 108 Stat. 4106 (1994) (codified as amended in various section of 11 U.S.C. and 28 U.S.C.) [hereinafter Bankruptcy Code or Code].

[10] Rome v. Braunstein, 19 F.3d 54, 57 (1st Cir. 1994). "The Bankruptcy Code imposes particularly rigorous conflict-of-interest restraints upon the employment of professional persons in a bankruptcy case." *Rome*, 19 F.3d at 57. *See also In re* Cropper Co., 35 B.R. 625, 629-30 (Bankr. M.D. Ga. 1983) (noting "strict standards" unique to bankruptcy cases); 3 COLLIER ON BANKRUPTCY, ¶ 327.03 at 327-14 & n.2 (Lawrence P. King et al. eds., 15th ed. rev. 1996) (noting that requirements of 11 U.S.C. § 327 should be rigidly applied.).

jurisdiction where the attorney is practicing.[11]

However, in the chapter 11 arena, an attorney representing the debtor-in-possession (DIP) has a particularly complicated role as counselor and advisor. This is because the debtor-in-possession is a fiduciary to the estate[12] and the attorney

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It is important to note that compensation under 11 U.S.C. § 330(a) is given administrative expense priority, and thus first priority, as provided under title 11. 11 U.S.C. § 507(a)(1) (1994) provides: "The following expenses and claims have priority in the following order: (1) First, administrative expenses allowed under section 503(b) of this title. . . . " 11 U.S.C. § 507(a)(1). Section 503(b)(2) provides: "After notice and a hearing, there shall be allowed administrative expenses, . . . including — compensation and reimbursement awarded under section 330(a) of this title." 11 U.S.C. § 503(b)(2) (1994). Thus, the bankruptcy courts' strict enforcement of the Code's and Rules' requirements is logical. If an attorney performs services not in compliance with the Code and Rules, he should not be compensated to the detriment of other creditors. Perhaps the importance of awarding compensation under section 330 is best stated in the legislative history as follows:

> There is inherent a "public interest" that "must be considered in awarding fees." An allowance is the result of a balance struck between moderation in the interest of the estate and its security holders and the need to be "generous enough to encourage" lawyers and others to render the necessary and exacting services that bankruptcy cases often require.

S. REP. NO. 95-989, at 40 (1978) (citations omitted).

[11] *See infra* note 203 and accompanying text.

[12] *See, e.g., In re* N.S. Garrott & Sons, 63 B.R. 189, 191 (Bankr. E.D. Ark. 1986) (stating that, as a fiduciary, a debtor-in-possession "owes undivided loyalty to the estate. *See also* Daniel B. Bogart, *Liability of Directors of Chapter 11 Debtors in Possession: "Don't Look Back—Something May Be Gaining on You,"* 68 AM. BANKR. L.J. 155, 212 (1994) (citing Wolf v. Weinstein, 372 U.S. 633, 649-50 (1963)) ("[A] DIP has the fiduciary obligations of a trustee."); *cf.* Commodity Futures Trading Comm'n v. Weintraub, 471 U.S. 343, 355 (1985) ("If a debtor remains in possession, . . . the debtor's directors have essentially the same fiduciary obligation to creditors and shareholders as would the trustee for a debtor out of possession").

Mr. Bogart also points out that Congress had similar notions concerning the relationship of the DIP and the trustee. He quotes the following legislative history:

> This section places a debtor in possession in the shoes of a trustee in every way. The debtor is given the rights and powers of a chapter 11 trustee. He's required to perform the functions and duties of a chapter 11 trustee (except the investigative duties). He is subject to any limitations on a chapter 11 trustee, and to such other limitations and conditions as the court prescribes.

Bogart, 68 AM. BANKR. L.J. at 212 n.310 (quoting S. REP. NO. 95-989, at 116 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5902; H. REP. NO. 95-595, at 404

must advise the client concerning those fiduciary duties.[13] The attorney's role as counselor and advisor is even more complicated because there "has been little detailed analysis of the fiduciary obligations of the DIP."[14] A fiduciary is "a person, having duty created by his undertaking, to act primarily for another's benefit in matters connected with such undertaking."[15] However, this definition is not very helpful when an

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(1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6360). This legislative history explicitly indicates that the debtor-in-possession is in fact a fiduciary, at least to the extent that a trustee appointed under the Code would be.

Mr. Bogart bolsters his assertion that the debtor-in-possession is in fact a fiduciary by not only relying on the explicit legislative history but also by collecting a number of cases in accord with this proposition. His collection of cases and his parenthetical analysis is as follows:

> United States v. Technical Knockout Graphics, Inc. (*In re* Technical Knockout Graphics, Inc.), 833 F.2d 797, 802 (9th Cir. 1987) ("The debtor-in-possession is not free to deal with this property as it chooses, but rather holds it in trust for the benefit of creditors, just as would a trustee."); United States v. Aldrich (*In re* Ridgen), 795 F.2d 727, 730 (9th Cir. 1986); *In re* Regensteiner Printing Co., 122 B.R. 323 (N.D. Ill. 1990) (the debtor, as representative of the estate, occupies a trust relationship subject to fiduciary obligations which include a prohibition of self-dealing); *In re* Microwave Prods., 102 B.R. 666, 671 (Bankr. W.D. Tenn. 1989) (DIP breached fiduciary obligations of fair dealing and loyalty; court states that these are same standards as applied to trustees in bankruptcy); Central Transp. v. Roberto (*In re* Tucker Freight Lines), 62 B.R. 213, 217 (Bankr. W.D. Mich. 1986).

Bogart, 68 AM. BANKR. L.J. at 212, n.310.

[13] *See In re* United Utensils Corp., 141 B.R. 306, 309 (Bankr. W.D. Pa. 1992) ("An attorney for the debtor has a fiduciary duty not only to the debtor, but has a fiduciary obligation to act in the best interest of the entire estate, including creditors). (citations omitted). If the debtor is not fulfilling *its* fiduciary obligation to the estate, it is the responsibility and duty of Debtor's counsel to bring such matters to the attention of the court." (citation omitted)). *See also In re* Wilde Horse Enters., 136 B.R. 830, 840 (Bankr. C.D. Cal. 1991) (stating that duty of attorney extends past client to unsecured creditors); *In re* Plaza Hotel Corp., 111 B.R. 882, 890 (Bankr. E.D. Cal. 1990) (disqualifying attorney for not correctly advising and assisting debtor); *In re* Consupak, Inc., 87 B.R. 529, 549 (Bankr. N.D. Ill. 1988) (noting that attorney must advise trustee of duty to invest funds of estate); NORTON BANKR. LAW & PRACTICE 2d § 27:6 (citing Commodity Futures Trading Comm'n v. Weintraub, 471 U.S. 343 (1985)) (stating generally that attorney owes ethical obligations to DIP client).

[14] Bogart, *supra* note 12, at 213 (citing Fulton State Bank v. Schipper (*In re* Schipper), 112 B.R. 917, 918-19 (Bankr. N.D. Ill. 1990)).

[15] BLACK'S LAW DICTIONARY 625 (6th ed. 1990).

attorney attempts to counsel a debtor-in-possession as to what the actual fiduciary duties are.[16]

In a Chapter 11 bankruptcy case, the problem is more severe because the debtor is often a corporate entity. This situation complicates the difficulty in counseling the debtor-in-possession on the appropriate legal steps in his position as a fiduciary. The corporate structure exacerbates the situation because of the many components within the corporation, including: "the collective directors, managers, employees, and classes of shareholders, as well as individual directors and managers."[17] Outside of a bankruptcy proceeding, these parties and interests often collide and the attorney of the corporation is often burdened with challenging questions of ethics and conflicts of interests.[18] These diverse interests and the stringent conflict-free requirements of the Bankruptcy Code will often make the attorney representing a chapter 11 DIP face a wide array of ethical quandaries. Perhaps the ethical difficulties of a chapter 11 attorney are best and succinctly stated as follows:

> [T]he Code clearly contemplates that the debtor can negotiate with the creditor groups to reduce or reallocate amounts flowing to creditor classes in order to effect a plan. In doing so, the debtor may even seek to preserve values to equity security holders when the "fair and equitable rule" would otherwise deny their participation. (citation omitted). Does this not inherently place counsel in the position of representing conflicting interests?[19]

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[16] For an excellent analysis of the fiduciary duties of a corporate debtor-in-possession, see Bogart, *supra* note 12, at 212-27.

[17] Robert J. Landry, III, Comment, *Joint Representation of a Corporation and Director/Officer Defendants in a Stockholder Derivative Suit: Is it Permissible?* 18 J. LEGAL PROF. 365 n.2 (1993) (citing James R. McCall, *The Corporation as Client: Problems, Perspectives, and Partial Solutions*, 39 HASTING L.J. 623, 623 n.2 (1988)).

[18] *See generally* Landry, *supra* note 17, at 365 (analyzing difficulties of representing corporation and individual director/officer defendants in stockholder derivative suit in nonbankruptcy context).

[19] *In re* Amdura Corp., 121 B.R. 862, 865 (Bankr. D. Colo. 1990).

This article will analyze: the requirements for retention and disclosure of counsel under the Code and Rules; the awards of compensation and sanctions for violations of these requirements, including a review of the Bankruptcy Reform Act of 1994 amendments affecting compensation of counsel; and finally, a brief review of the ramifications of the Rules of Professional Conduct on counsel for the chapter 11 debtor-in-possession.

II. Eligibility of Attorney as Counsel for Debtor-in-Possession.[20]

A. Requirements for Retention Under the Bankruptcy Code.

11 U.S.C. § 327(a) provides the basic requirements with which attorneys must comply in order for the court to approve employment of general counsel by the trustee or debtor-in-possession.[21] Before examining the substantive requirements of

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[20] It is important to note here that this article will only address attorneys employed under 11 U.S.C. § 327(a) or "general counsel" for the debtor-in-possession conducting the case. 11 U.S.C. § 327(e) provides for the employment of "special counsel":

> The trustee, with the court's approval, may employ, for a specified special purpose, other than to represent the trustee in conducting the case, an attorney that has represented the debtor, if in the best interest of the estate, and if such attorney does not represent or hold any interest adverse to the debtor or to the estate with respect to the matter on which such attorney is to be employed.

11 U.S.C. § 327(e) (1994).

The standard for employment of "special counsel" is not as stringent as the standard for employment under 11 U.S.C. § 327(a). The focus of employment as "special counsel" will be whether the attorney represents or holds an "interest adverse to the debtor or to the estate with respect to the matter on which such attorney is to be employed." 11 U.S.C. § 327(e). The attorney employed as "special counsel" need not be "disinterested" as is required under 11 U.S.C. § 327(a). *See* NORTON BANKR. LAW AND PRACTICE 2d § 25:5. *See also In re* Interstate Distr. Ctr. Assoc. (A), Ltd., 137 B.R. 826, 831 (Bankr. D. Colo. 1992) (stating that attorneys employed under 11 U.S.C. § 327(e) need not be "disinterested persons" like attorneys employed under subsection (a)).

In cases arising under 11 U.S.C. § 327(e), the issue will often be whether the attorney is actually being retained as required under the Code. The attorney must be retained "for a special purpose, other than to represent the trustee in conducting the case. . . ." 11 U.S.C. § 327(e). It will often be difficult to distin-

guish between employment for a special purpose and "conducting the case." Although an attorney's purpose is "special," the purpose can be in connection with the "trustee in conducting the case" and if a court finds that the attorney was not employed as a section 327(e) "special counsel," then the attorney must satisfy the requirements of 11 U.S.C. § 327(a). For several recent cases discussing this interplay of 11 U.S.C. §§ 327(a) and 327(e), see: *In re* Neuman, 138 B.R. 683, 685 (S.D.N.Y. 1992) (recognizing different criteria for appointment of counsel under §§ 327(a) & 327(e)); *In re* F & C Int'l, 159 B.R. 220, 222 (Bankr. S.D. Ohio 1993) (addressing different standards for conflicts of interest under §§ 327(a) & 327(e)); *In re* Servico, Inc., 149 B.R. 1009, 1013 (Bankr. S.D. Fla. 1993) (noting different standards for approval of attorneys under §§ 327(e) & 327(a)). Furthermore, this article does not specifically address the employment of "other professional persons" under 11 U.S.C. § 327(a). It is important to note that many of the same concepts discussed regarding not holding "an interest adverse to the estate" and "disinterested" will apply to "other professionals" sought to be employed by the debtor-in-possession and many cases cited in this article will in fact deal with "other professionals." However, the principles are transferable to attorneys employed under 327(a). Perhaps the largest barrier to the employment of "other professionals" under 11 U.S.C. § 327(a), other than the conflict-free requirements of the Code, will be whether the person sought to be employed is in fact a "professional."

The difficulty lies in the fact that "professional" is not defined in title 11. Therefore, whether the particular person is a "professional" will largely depend on the services to be rendered in each particular case. The following cases provide a beginning point of research for determining whether a person is a professional and indicate the wide range of persons who may be a "professional" under 11 U.S.C. § 327(a). Note that the facts in any particular case may or may not render someone a professional under 327(a). The focus will be on the role the person plays in the case.With that in mind, people in the following occupations have been found to be professionals:

-*Real estate broker: In re* C.H. Stuart, Inc., 16 B.R. 296 (Bankr. W.D.N.Y. 1981); *In re* Cummins, 8 B.R. 701 (Bankr. C.D. Cal. 1981), *rev'd on other grounds*, 15 B.R. 893 (B.A.P. 9th Cir. 1981).

-*Architect: In re* Holiday Mart, Inc., 18 B.R. 212 (Bankr. D. Haw. 1982). The *Holiday Mart* court, while denying compensation because the architect failed to receive court approval for his services, implicitly held that an architect was a professional under 11 U.S.C. § 327(a). *Holiday Mart*, 18 B.R. at 216.

-*Management consultant or consulting firms*: *In re* El Paso Refinery, L.P., 155 B.R. 418 (Bankr. W.D. Tex. 1993); *In re* WFDR, Inc. 22 B.R. 266 (Bankr. N.D. Ga. 1982).

-*Auctioneers: In re* Rheam of Ind., Inc., 137 B.R. 151 (Bankr. E.D. Pa. 1992), *vacated on other grounds*, 142 B.R. 698 (E.D. Pa. 1992).

11 U.S.C. § 327(a), it is important to recognize that only the trustee or debtor-in-possession can employ counsel.[22] Furthermore, bankruptcy courts may not use their equitable powers under 11 U.S.C. § 105(a)[23] and 28 U.S.C. § 2283[24] to approve a professional by entities other than the trustee or DIP.[25]

The following occupations have been found not to be professionals:

-*Maritime engineers*: *In re* Seatrain Lines, Inc., 13 B.R. 980 (Bankr. S.D.N.Y. 1981). The *Seatrain* court focused on whether engineers who, outside of bankruptcy were clearly "professionals," were persons whose occupation played a central role in the administration of the debtor's case. *Seatrain*, 13 B.R. at 981. The court found that their role would not affect the administration of the debtor's case and, therefore, they were not "other professionals." *Id.*

-*Officers of a debtor-in-possession corporation: In re* Lyon & Reboli, Inc., 24 B.R. 152, 153 (Bankr. E.D.N.Y. 1982). Only professionals who play a central role in the administration of the case are "other professionals." *Reboli*, 24 B.R. at 153. Officers are not within the class of persons contemplated under 327(a) and court approval is not generally required to continue to employ such officers. *Id.* at 153-54.

-*Lobbyists: In re* Johns-Manville Corp., 60 B.R. 612 (Bankr. S.D.N.Y. 1986). Lobbyists' activities were performed in the ordinary course of business for many years prior to the bankruptcy, thus they did not assist the debtor-in-possession carry out the duties prescribed by title 11. *Johns-Manville*, 60 B.R. at 618-20.

[21] The debtor-in-possession has this authority under 11 U.S.C. § 1107(c) (1994) and FED. R. BANKR. P. 9001(10).

[22] *In re* Office Prods. of Am., Inc., 136 B.R. 675, 680 (Bankr. W.D. Tex. 1992).

[23] 11 U.S.C. § 105(a) provides:

> The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, sua sponte, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process.

11 U.S.C. § 105(a) (1994).

[24] 28 U.S.C. § 2283 provides: "A court . . . may not grant an injunction to stay proceedings in a State court except as expressly authorized by Act of Congress, or where necessary in aid of its jurisdiction, or to protect or effectuate its judgments." 28 U.S.C. § 2283 (1994).

[25] *In re* WAPI, Inc., 171 B.R. 130, 133 (Bankr. N.D. Ala. 1994) ("The bankruptcy courts may not use their equitable powers if to do so would strip another Code provision of its meaning"). One court noted that section 105(a) does not

Section 327(a) provides:

> Except as otherwise provided in this section, the trustee, with the court's approval, may employ one or more attorneys, accountants, appraisers, auctioneers, or other professional persons, that do not hold or represent an interest adverse to the estate, and that are disinterested persons, to represent or assist the trustee in carrying out the trustee's duties under this title.[26]

The attorney to be employed must (1) not "hold an interest adverse to the estate" and (2) must be a "disinterested person."[27] The phrase "interest materially adverse to the estate" is not defined in the Bankruptcy Code, but has been interpreted to mean:

> [H]olding or representing an interest adverse to the estate as possessing, *or serving as an attorney for a person possessing*, either an 'economic interest that would tend to lessen the value of the bankruptcy estate *or* that would create either an actual or potential dispute in which the estate is a rival claimant . . . *or* . . . a predisposition under the circumstances that render such a bias against the estate.[28]

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necessarily "constitute a roving commission to do equity." United States v. Sutton, 786 F.2d 1305, 1308 (5th Cir. 1986). *See also In re* Energy Co-Op, Inc., 95 B.R. 961, 964 (Bankr. N.D. Ill. 1988) (noting that court may not allow payment for counsel to Chapter 7 creditor's committee); *In re* Transamerican Freight Lines, Inc., 40 B.R. 88, 90 (Bankr. E.D. Mich. 1984) (stating that only lawyers representing entities authorized by court to have lawyers may be paid from estate).

Regarding the courts' use of the powers under 11 U.S.C. § 105, one commentator stated:

> Regardless of the view adopted, it should be universally recognized that the power granted to the bankruptcy courts under section 105 is not boundless and should not be employed as a panacea for all ills confronted in the bankruptcy case. Section 105 does not allow the bankruptcy court to override explicit mandates of other sections of the Bankruptcy Code or mandates of other state and federal statutes.

2 COLLIER ON BANKRUPTCY, ¶ 105.01[2], at 105-06 to 105-7 (Lawrence P. King et al. eds., 15th ed. rev. 1996) (citations omitted).

[26] 11 U.S.C. § 327(a) (1994).

[27] 11 U.S.C. § 327(a) (1994).

[28] *In re* Prince, 40 F.3d 356, 361 (11th Cir. 1994) (quoting *In re* Roberts, 46 B.R. 815, 822-23 (Bankr. D. Utah 1985)) (emphasis added). *See also In re* Michi-

11 U.S.C. § 101(14) defines a "disinterested person" and includes within this classification: creditors, equity security holders, insiders, investment bankers for outstanding securities of the debtor, persons who were investment bankers (or counsel) for securities of the debtor within three years of filing the petition, persons who were directors, officers or employees of the debtor or of said investment bankers within two years of filing, and persons holding an interest materially adverse to the estate or creditors or equity security holders.[29]

B. The Requirement of Disclosure Under the Bankruptcy Rules

Federal Rule of Bankruptcy Procedure 2014 mandates that any professional, especially an attorney, seeking approval of employment under 11 U.S.C. §§ 327 and 1103 must submit a "verified statement . . . setting forth the person's connections" to all parties in interest to the proceeding.[30]

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gan Gen. Corp., 78 B.R. 479, 484 (Bankr. N.D. Tex. 1987) (noting that attorney must look to all sources of recovery by estate and that any adverse interest to estate would render that search impossible).

[29] 11 U.S.C. § 101(14) reads in full:

> "[D]isinterested person" means person that-
>
> (A) is not a creditor, an equity security holder, or an insider;
>
> (B) is not and was not an investment banker for any outstanding security of the debtor;
>
> (C) has not been, within three years before the date of the filing of the petition, an investment banker for a security of the debtor, or an attorney for such an investment banker in connection with the offer, sale, or issuance of a security of the debtor;
>
> (D) is not and was not, within two years before the date of the filing of the petition, a director, officer, or employee of the debtor or of an investment banker specified in subparagraph (B) or (C) of this paragraph; and
>
> (E) does not have an interest materially adverse to the interest of the estate or of any class of creditors or equity security holders, by reason of any direct or indirect relationship to, connection with, or interest in, the debtor or an investment banker specified in subparagraph (B) or (C) of this paragraph, or for any other reason.

11 U.S.C. § 101(14) (1994).

[30] FED. R. BANKR. P. 2014(a). The rule provides in full:

The attorney seeking employment has the burden of making a complete and candid disclosure of all facts pertinent to the court's decision to approve employment.[31] Disclosure is compulsory and it is the "responsibility of the professional, not of the court, to make sure that all relevant connections have been brought to light."[32] Only after a complete disclosure can

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> An order approving the employment of attorneys, accountants, appraisers, auctioneers, agents, or other professionals pursuant to § 327, § 1103, or § 1114 of the Code shall be made only on application of the trustee or committee. The application shall be filed and, unless the case is a chapter 9 municipality case, a copy of the application shall be transmitted by the applicant to the United States trustee. The application shall state the specific facts showing the necessity for the employment, the name of the person to be employed, the reasons for the selection, the professional services to be rendered, any proposed arrangement for compensation, and, to the best of the applicant's knowledge, all of the person's connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the United State trustee, or any person employed in the office of the United States trustee. The application shall be accompanied by a verified statement of the person to be employed setting forth the person's connections with the debtor, creditors, or any other party in interest, their respective attorneys and accountants, the United States trustee, or any person employed in the office of the United States trustee.

Id.

[31] Rome v. Braunstein, 19 F.3d 54, 59 (1st Cir. 1994). The *Rome* court makes clear that the provisions for disclosure cannot effectively function without a thorough and completely forthright initial disclosure from the attorney requesting employment. *Rome*, 19 F.3d at 59. *See also In re* Prudhomme, 152 B.R. 91, 105-12 (Bankr. W.D. La. 1993) (commenting on obligation of continuing disclosure by applicant), *aff'd sub nom.* Arens v. Boughton, 176 B.R. 781 (W.D. La. 1993), *aff'd*, 43 F.3d 1000 (5th Cir. 1995), *affid sub nom.* Arens v. Boughton, 176 B.R. 781 (W.D. La. 1993), *aff'd*, 43 F.3d 1000 (5th Cir. 1995).

[32] *In re* Leslie Fay Cos., 175 B.R. 525, 533 (Bankr. S.D.N.Y. 1994).

Furthermore, United States Trustees or creditors have no duty "to search the record for the existence, vel non, of a conflict of interest of a professional sought to be employed." *In re* Marine Outlet, Inc., 135 B.R. 154, 156 (Bankr. M.D. Fla. 1991). The *Marine Outlet* court further stated:

> [T]here is a definite affirmative duty placed on a professional to disclose his or her connection with parties whose interest is or may be antagonistic or opposite to the interest of the general estate and a failure to comply with the mandate of Bankruptcy Rule 2014(a) merits a total forfeiture of all fees.

Marine Outlet, 135 B.R. at 156 (citing *In re* B.E.S. Concrete Prods., Inc., 93 B.R.

the court make an informed decision regarding the attorney's proposed employment.[33] The purpose of the rule is to

> provide the court (and the United States Trustee) with information necessary to determine whether the professional's employment meets the broad test of being in the best interest of the estate. To that end, a failure to disclose any fact which may influence the court's decision may result in a later determination that disclosure was inadequate and sanctions should be imposed on the professional. The fact that disclosure was made elsewhere (e.g., in the debtor's schedules) is not likely to ameliorate a court's reaction to incomplete disclosure.[34]

Once the attorney is appointed, it is not necessary for other members of a firm to obtain separate approval from the court. Federal Rule of Bankruptcy Procedure 2014(b) explicitly permits an associate or partner of an approved attorney to act as the debtor-in-possession's attorney without further order of the court.[35] Although an associate or attorney may act without court approval under Rule 2014(b), attorneys must be cautious to make sure no conflicts arise with any attorney in the firm because the disclosure requirements under Rule 2014(a) are continuing. "If [a] potential conflict arise[s] after approval of

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228, 237 (Bankr. E.D. Cal. 1988)).

[33] *In re* Diamond Mortg. Corp., 135 B.R. 78, 96-98 (Bankr. N.D. Ill. 1990). The *Diamond Mortg. Corp.* court found that the failure to disclose all necessary facts provided a sufficient basis for reducing or denying fees. *Diamond Mortg. Corp.*, 135 B.R. at 98.

[34] 9 COLLIER ON BANKRUPTCY ¶ 2014.03 (Lawrence P. King et al. eds., 15th ed. rev. 1996).

[35] FED. R. BANKR. P. 2014(b). The rule provides:

> If, under the Code and this rule, a law partnership or corporation is employed as an attorney, or an accounting partnership or corporation is employed as an accountant, or if a named attorney or accountant is employed, any partner, member, or regular associate of the partnership, corporation or individual may act as attorney or accountant so employed, without further order of the court.

Id. *See also* *In re* Butler Indus., Inc., 114 B.R. 695, 698 (C.D. Cal. 1990) (approving appointment of law firm of which trustee was a member), *appeal dismissed*, 8 F.3d 25 (9th Cir. 1993); *In re* Siesta Sands Dev. Corp., 95 B.R. 812, 815 (Bankr. M.D. Fla. 1989) (reiterating Rule's permission of other members of firm to represent DIP) *rev'd on other grounds*, 118 B.R. 108 (M.D. Fla. 1990).

the application, the professional must advise the Court."[36]

III. AWARDS OF COMPENSATION, REIMBURSEMENTS OF EXPENSES AND THE LIMITS THEREON.

11 U.S.C. § 330(a)[37] provides the substantive basis for an

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[36] *Prudhomme*, 152 B.R. at 105-12. *See also In re* ESM Gov't Secs., Inc., 66 B.R. 82, 84 (S.D. Fla. 1986) (disqualifying law firm because member represented opposing party in related proceeding); *In re* Cropper Co., 35 B.R. 625, 632 (Bankr. M.D. Ga. 1983) (holding that where associate violated disclosure rules, court could dismiss entire firm).

[37] 11 U.S.C. § 330(a) provides:

> (1) After notice to the parties in interest and the United States Trustee and a hearing, and subject to sections 326, 328, and 329, the court may award to a trustee, an examiner, a professional person employed under section 327 or 1103-
>
> (A) reasonable compensation for actual, necessary services rendered by the trustee, examiner, professional person, or attorney and by any paraprofessional person employed by any such person; and
>
> (B) reimbursement for actual, necessary expenses.
>
> (2) The court may, on its own motion or on the motion of the United States Trustee, the United States Trustee for the District or Region, the trustee for the estate, or any other party in interest, award compensation that is less than the amount of compensation that is requested.
>
> (3) In determining the amount of reasonable compensation to be awarded, the court shall consider the nature, the extent, and the value of such services, taking into account all relevant factors, including-
>
> (A) the time spent on such services;
>
> (B) the rates charged for such services;
>
> (C) whether the services were necessary to the administration of, or beneficial at the time at which the service was rendered toward the completion of, a case under this title;
>
> (D) whether the services were performed within a reasonable amount of time commensurate with the complexity, importance, and nature of the problem, issue, or task addressed; and
>
> (E) whether the compensation is reasonable based on the customary compensation charged by comparably skilled practitioners in cases other than cases under this title.
>
> (4)(A) Except as provided in subparagraph (B), the court shall not allow compensation for-
>
> (i) unnecessary duplication of services; or
>
> (ii) services that were not-
>
> (I) reasonably likely to benefit the debtor's estate; or
>
> (II) necessary to the administration of the case.

attorney for the debtor-in-possession to receive compensation for services rendered and reimbursement of expenses incurred.[38] Federal Rule of Bankruptcy Procedure 2016(a) provides the procedural mechanism by which an attorney can seek compensation under §330(a).[39] Under this Rule, the attorney

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(B) In a chapter 12 or chapter 13 case in which the debtor is an individual, the court may allow reasonable compensation to the debtor's attorney for representing the interests of the debtor in connection with the bankruptcy case based on a consideration of the benefit and necessity of such services to the debtor and the other factors set forth in this section.

(5) The court shall reduce the amount of compensation awarded under this section by the amount of any interim compensation awarded under section 331, and, if the amount of such interim compensation exceeds the amount of compensation awarded under this section, may order the return of the excess to the estate.

(6) Any compensation awarded for the preparation of a fee application shall be based on the level and skill reasonably required to prepare the application.

111 U.S.C. § 330(a) (1994).

[38] *See supra* note 10, para. 2.

[39] FED. R. BANKR. P. 2016(a). The rule provides:

An entity seeking interim or final compensation for services, or reimbursement of necessary expenses, from the estate shall file . . . an application setting forth a detailed statement of (1) the services rendered, time expended and expenses incurred, and (2) the amounts requested. An application for compensation shall include a statement as to what payments have theretofore been made or promised to the applicant for services rendered or to be rendered in any capacity whatsoever in connection with the case, the source of the compensation so paid or promised, whether any compensation previously received has been shared and whether an agreement or understanding exists between the applicant and any other entity for the sharing of compensation received or to be received for services rendered in or in connection with the case, and the particulars of any sharing of compensation or agreement or understanding therefor, except that details of any agreement by the applicant for the sharing of compensation as a member or regular associate of a firm of lawyers or accountants shall not be required. The requirements of this subdivision shall apply to an application for compensation for services rendered by an attorney or accountant even though the application is filed by a creditor or other entity. Unless the case is a chapter 9 municipality case, the applicant shall transmit to the United States trustee a copy of the application.

Id.

must make an application for compensation and reimbursement of expenses.[40] The attorney must also set forth a detailed statement and request a specific amount for the services performed, time expended and the expenses incurred.[41] Furthermore, the application must include all payments previously received or promised and the source of such payments.[42] Finally, any agreement to share the compensation with anyone must be disclosed.[43]

Section 330 specifically limits compensation and reimbursement of expenses to attorneys employed under section 327 or 1103.[44] Furthermore, section 330 explicitly subjects the award of compensation to sections 326, 328 and 329 and requires that compensation for services be for reasonable "actual, necessary services" and that the reimbursement of expenses be for "actual, necessary expenses."[45] Thus, from reading sections 330, 328, 327 and Rule 2014 several restrictions on compensation arise.

These restrictions include:

A. The court may only award a reasonable amount of compensation.

B. The attorney must comply with the application requirements as mandated by Federal Rule of Bankruptcy Procedure 2014(a).[46]

C. The attorney must make a complete disclosure at the time of application and that requirement is continuing in nature.[47]

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[40] *Id.*

[41] *Id.*

[42] *Id.*

[43] *Id.* Members or associates in a law firm who divide compensation between themselves need not disclose their method of division. *Id.*

[44] 11 U.S.C. § 330(a)(1) (1994). *See supra* note 37 for the text of U.S.C. § 330(a)(1).

[45] 11 U.S.C. § 330(a)(1)(A)-(B).

[46] Since the attorney must be employed under section 327(a), the attorney must comply with the disclosure and application requirements mandated by Federal Rule of Bankruptcy Procedure 2014(a).

[47] The requirements under section 327(a), i.e., disinterested and not hold an interest adverse to the estate, must be complied with in order to be appointed. If the attorney is appointed and the requirements were not satisfied, compensation

D. The attorney must be conflict free for employment under section 327(a), and that requirement is continuing in nature pursuant to section 328(c).[48]

There is considerable overlap of these grounds and usually a denial of compensation will be based on several of them. It is important to recognize that although the sanctions may be for violations of the disclosure rules or violations involving actual substantive conflicts of interest, each violation is an independent ground for various sanctions.[49] The fundamental reason to sanction or deny compensation to an attorney employed in violation of section 330 is that an attorney "who holds or represents an interest materially adverse to the estate and is employed by the estate as a consequence of a violation of the disclosure rules, or comes into that conflict subsequent to employment, is *not an officer of the estate* during the time of the conflict and therefore is not entitled to compensation under § 330(a)."[50]

It is important to note that it is always the applicant's burden to prove entitlement to the fees[51] and expenses[52] re-

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may be denied. 11 U.S.C. § 330(a)(1).

[48] 11 U.S.C. § 330(a)(1) expressly refers to section 328. Section 328(c) expressly permits the court to deny compensation if the attorney was (1) not a disinterested person or (2) represented or held an interest adverse to the estate with respect to the scope of the attorney's employment. 11 U.S.C. § 328(c). These requirements mirror section 327(a); thus, the requirements for initial conflict-free employment are continuing by virtue of section 328(c). Even if the Code did not have section 328(c), a court could still deny fees if, the employment violating 328(c) also violates section 327(a). However, this section makes it clear that fees can be reduced.

[49] *In re* EWC, Inc.B.R. 276, 281 (Bankr. W.D. Okla. 1992).

[50] *EWC*, 138 B.R. at 281 (emphasis added).

[51] *In re* Spanjer Bros., Inc., 191 B.R. 738, 747 (Bankr. N.D. Ill. 1996) (citing *In re* Kenneth Leventhal & Co., 19 F.3d 1174, 1177 (7th Cir. 1994); *In re* Stoecker, 114 B.R. 965, 969 (Bankr. N.D. Ill. 1990); *In re* Pettibone Corp., 74 B.R. 293, 299 (Bankr. N.D. Ill. 1987)). *See also In re* Harman Supermarket, Inc., 44 B.R. 918, 920 (Bankr. W.D. Va. 1984) (stating that hours worked should not be sole factor considered when calculating fees); *In re* Horn & Hardart Baking Co., 30 B.R. 938, 939-40 (Bankr. E.D. Pa. 1983) (noting that application must include information sufficient enough for court to determine appropriate fee).

[52] *Spanjer Bros., Inc.*, 191 B.R. at 749. The *Spanjer* court noted that no court

quested. The burden is "not [to] be taken lightly, especially given that every dollar expended on legal fees results in a dollar less that is available for distribution to the creditors."[53] Applicants must be meticulous in their application and supporting documents.

A. The Court May Only Award a "Reasonable" Amount of Compensation.

1. Court's Duty to Review.

Implicit in the Court approving only a "reasonable" amount of compensation is that the bankruptcy court in its discretion, decides on the award under 11 U.S.C. § 330.[54] Thus, even if the applicant attorney has complied with the above referenced limits on employment, section 327 and Rule 2014, and not violated 328(c), the court may limit the award and is expressly authorized to do so *sua sponte* under § 330(a)(2) as amended by the Bankruptcy Reform Act of 1994.[55] The court has the power

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will assume a particular expense was necessary. *Id.* (citing *In re* Lindberg Prods., Inc., 50 B.R. 220, 221 (Bankr. N.D. Ill. 1985)). Expenses are necessary only when incurred to effect "proper representation." *Id.* (citing *In re* Wildman, 72 B.R. 700, 731 (Bankr. N.D. Ill. 1987)).

[53] *Spanjer Bros.*, 191 B.R. at 747 (citations omitted).

[54] 9 AM. JUR. 2d *Bankruptcy* § 322, at 339-40. The section provides, in pertinent part:

> Review of a fee petition is left to the sound discretion of the bankruptcy judge, regardless of the degree of success of the petitioner's efforts, the debtor's satisfaction with such performance, and the lack of objection to the fee petition; the Bankruptcy Court must under 11 USCS § 330(a)(1) review a request for compensation, and the decision my be reviewed on appeal to the District Court only under an abuse of discretion standard and should be reversed only when the Bankruptcy Court fails to apply proper procedures or legal standards or bases its award upon findings of fact that are clearly erroneous.

Id. (citing *In re* National Paragon Corp., 87 B.R. 11, 13 (E.D. Pa. 1988)). *See also* Matter of Nor-les Sales, Inc., 32 B.R. 900, 902 (Bankr. E.D. Mich. 1983) ("The amount [of compensation] to be allowed is left to the sound discretion of the court."), *modified sub nom.* Stark & Reagan, P.C. v. Nor-les Sales, 53 B.R. 442 (1984) (E.D. Mich.).

[55] Bankruptcy Reform Act of 1994, § 224, Pub. L. No. 103-394, 108 Stat. 4106 (1994).

to limit an award of compensation or reimbursement even in the absence of an objection to the application. The permissive language of section 330 — "the court *may* award" — implies that the award of compensation or reimbursement is within the court's discretion, to the extent the court complies with the limitations of section 330(a). Section 105 empowers the court *sua sponte* to take any action or make any determination necessary or appropriate to enforce or implement orders or rules.[56] Under Rule 2017(b), the court may determine, on its own initiative and in the absence of any motion of a party in interest, whether any payment by the debtor to an attorney for services is excessive. The court, therefore, even in the absence of an objection to the application, has both the power and the duty to determine the proper amount of compensation based on the limitations specified by the Code.[57] This authority to review

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[56] 11 U.S.C. § 105 (1994).

[57] For cases from a variety of jurisdictions addressing the broad power of the court to determine fees, see *In re* Busy Beaver Bldg. Ctrs., Inc., 19 F.3d 833, 843, n.8 (3d Cir. 1994); *In re* NRG Resources, Inc., 64 B.R. 643, 650 (W.D. La. 1986); *In re* Ralph Marcantoni & Sons, Inc., 62 B.R. 245, 247 (D. Md. 1986); Cohen & Thiros, P.C. v. Keen Enters., Inc., 44 B.R. 570, 574-75 (N.D. Ind. 1984); *In re* Colonial Distrib. Co., 314 F. Supp.. 418, 420 (D.S.C. 1970) (pre- amendments); *In re* Maruko, Inc., 160 B.R. 633, 637 (Bankr. S.D. Cal. 1993); *In re* Corporacion de Servicios Medico-Hospitalarios de Fajardo, Inc., 155 B.R. 1, 2 (Bankr. D.P.R. 1993); *In re* Peter J. Schmitt Co., 154 B.R. 632, 634 (Bankr. D. Del. 1993); *In re* Evans, 153 B.R. 960, 967-68 (Bankr. E.D. Pa. 1993); *In re* Costello, 150 B.R. 675, 677 (Bankr. E.D. Ky. 1992); *In re* Bonneville Pac. Corp., 147 B.R. 803, 805 (Bankr. D. Utah 1992); *In re* Scoggins, 142 B.R. 940, 943 (Bankr. D. Or. 1992); *In re* Gillett Holdings, Inc., 137 B.R. 475, 480 (Bankr. D. Colo. 1992); *In re* Wilde Horse Enters., Inc., 136 B.R. 830, 839 (Bankr. C.D. Cal. 1991); *In re* Bank of New Eng. Corp., 134 B.R. 450, 453 (Bankr. E.D. Mass. 1991), *aff'd,* 142 B.R. 584 (D. Mass. 1992); *In re* Bennett, 133 B.R. 374, 377 (Bankr. N.D. Tex. 1991); *In re* East Peoria Hotel Corp., 145 B.R. 956, 959 (Bankr. C.D. Ill. 1991); *In re* Saturley, 131 B.R. 509, 516 (Bankr. D. Me. 1991); *In re* Viscount Furniture Corp., 133 B.R. 360, 362 (Bankr. N.D. Miss. 1991); *In re* Gold Seal Prods. Co., 128 B.R. 822, 827 & n.3 (Bankr. N.D. Ala. 1991); *In re* Sounds Distrib. Corp., 122 B.R. 952, 957 (Bankr. W.D. Pa. 1991); *In re* Amstar Amb. Serv., Inc., 120 B.R. 391, 394 (Bankr. N.D. W. Va. 1990); *In re* Zenith Lab., Inc., 119 B.R. 51, 54 (Bankr. D. N.J. 1990); *In re* Great Sweats, Inc., 113 B.R. 240, 242 (Bankr. E.D. Va. 1990); *In re* Gary Fairbanks, Inc., 111 B.R. 809, 811 (Bankr. N.D. Iowa 1990); *In re* Oberreich, 109 B.R. 936, 937 (Bankr. E.D. Wis. 1990); *In re* Bilgutay, 108 B.R. 333, 336 n.2 (Bankr. M.D. Fla. 1989); *In re* Inslaw, Inc., 106 B.R. 331, 333-34 (Bankr. D.D.C. 1989); *In re* Crimson Invs., N.V., 109 B.R. 397, 400 (Bankr. D. Ariz.1989); *In re*

Kroh Bros. Dev. Co., 105 B.R. 515, 520 (Bankr. W.D. Mo. 1989); *In re* Washington Mfg. Co., 101 B.R. 944, 950 (Bankr. M.D. Tenn. 1989); *In re* Tennessee Valley Ctr. for Minority Econ. Dev., 99 B.R. 845, 847 (Bankr. W.D. Tenn. 1989); *In re* Command Servs. Corp., 102 B.R. 905, 910 (Bankr. N.D.N.Y. 1989); *In re* Florida Brethren Homes, Inc., 97 B.R. 652, 653 n.2 (Bankr. S.D. Fla. 1989); *In re* Temple Retirement Community, 97 B.R. 333, 336, 338 (Bankr. W.D. Tex. 1989); *In re* Public Serv. Co. of N.H., 93 B.R. 823, 827 (Bankr. D.N.H. 1988); *In re* Gulf Consol. Servs., Inc., 91 B.R. 414, 415 (Bankr. S.D. Tex. 1988); *In re* Mayes, 101 B.R. 494, 496 (Bankr. W.D. Mich. 1988); *In re* Reed, 95 B.R. 626, 628 (Bankr. E.D. Ark. 1988); *In re* Garber, 88 B.R. 15, 16 (Bankr. D.R.I. 1988); *In re* Ross, 88 B.R. 471, 474-75 (Bankr. M.D. Ga. 1988); *In re* Pothoven, 84 B.R. 579, 583 (Bankr. S.D. Iowa 1988); *In re* Watkins Glen Grand Prix Corp., 81 B.R. 232, 234 n.5 (Bankr. W.D. N.Y. 1988); *In re* Jessee, 77 B.R. 59, 61 (Bankr. W.D. Va. 1987); *In re* Pettibone Corp., 74 B.R. 293, 299-300 (Bankr. N.D. Ill. 1987); *In re* Westfall, 73 B.R. 186, 189 & n.1 (Bankr. W.D. Ark. 1986); *In re* Mansfield Tire & Rubber Co., 65 B.R. 446, 455 (Bankr. N.D. Ohio 1986); *In re* Cuisine Magazine, Inc., 61 B.R. 210, 219 (Bankr. S.D.N.Y. 1986); *In re* Esar Ventures, 62 B.R. 204, 205 (Bankr. D. Haw. 1986); *In re* Four Star Terminals, Inc., 42 B.R. 419, 426 n.1 (Bankr. D. Alaska 1984); *In re* Thomas, Inc., 43 B.R. 510, 511 (Bankr. D. Mass. 1984); *In re* Garnas, 40 B.R. 140, 141 (Bankr. D.N.D. 1984); *In re* Watson Seafood & Poultry Co., 40 B.R. 436, 438 (Bankr. E.D.N.C. 1984); *In re* Daylight Transp., Inc., 42 B.R. 20, 21, 26 (Bankr. E.D. N.Y. 1984); *In re* Wilson Foods Corp., 36 B.R. 317, 320 (Bankr. W.D. Okla. 1984); *In re* Nor-les Sales, Inc., 32 B.R. 900, 902 (Bankr. E.D. Mich. 1983), *modified sub nom.* Stark & Reagan, P.C. v. Nor-les Sales, 53 B.R. 442 (E.D. Mich. 1984); *In re* International Coins & Curr., Inc., 26 B.R. 256, 260 (Bankr. D. Vt. 1982); *In re* Liberal Mkt., Inc., 24 B.R. 653, 657 (Bankr. S.D. Ohio 1982); *In re* Crutcher Transfer Line, Inc., 20 B.R. 705, 710 (Bankr. W.D. Ky. 1982). *See also In re* Gulf Hills Dev. Corp., 60 B.R. 366, 368 (Bankr. S.D. Miss. 1985) (stating court not bound by previous fee agreement). *But see In re* Jensen's Interiors, Inc., 132 B.R. 105, 106 (E.D. Pa. 1991) (noting court may not reduce fees unless requested by creditors or trustee); *cf. e.g., In re* Rheam of Ind., Inc., 142 B.R. 698, 700 (E.D. Pa. 1992) ("Rheam V") (stating that bankruptcy court's discretion is more circumscribed when no party objects).

The Third Circuit recognized such a duty has been established by bankruptcy commentators. *See Busy Beaver*, 19 F.3d at 844 n.9. The *Busy Beaver* court commented: "[T]he ultimate responsibility for assessing the reasonableness of compensation awarded to professionals and other officers of the estate remains . . . with the judiciary." *Id.* (alteration in original) *See also* R.E. GINSBURG, BANKRUPTCY ¶ 4501 (1985) ("Even if no party in interest objects, . . . the court should review the application to make sure that the compensation sought has been earned and is reasonable."); Harold Lavien, *Fees as Seen from the Bankruptcy Bench*, 89 COM. L.J. 136, 138 (1984) (suggesting alternative measures for fee determinations).

Furthermore, the legislative history provides support for this conclusion. *Busy Beaver*, 19 F.3d at 844 n.10. "The Joint Explanatory Statement describing the compromise on the Bankruptcy Reform Act, explains: "Attorneys' fees in bankruptcy cases can be quite large and *should be closely examined by the court.*" 124

the application *sua sponte* is nothing new because bankruptcy courts prior to the Reform Act, even absent objections to the fee application, were under a duty to carefully examine fee applications.[58]

The duty to review applications stems from the "inherent obligation to monitor the debtor's estate and to serve the public interest."[59] The Court of Appeals for the Third Circuit, quoting a bankruptcy court, succinctly stated the policy behind court review of applications:

> [T]he integrity of the bankruptcy system . . . is at stake in the issue of a bankruptcy judge's performance of the duty to review fee applications *sua sponte*. The public expects, and has a right to expect, that an order of a court is a judge's certification that the result is proper and justified under the law. . . . Nothing better serves to allay [public perceptions that high professional fees unduly drive up bankruptcy costs] than the

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CONG. REC. 32, 394 (1978) (Joint Explanatory Statement) (remarks of Rep. Edwards) (emphasis added), *reprinted in* 1978 U.S.C.C.A.N. 6436, 6442; *accord* 124 CONG. REC. 33, 994 (1978) (Joint Explanatory Statement) (remarks of Sen. DeConcini), *reprinted in* 1978 U.S.C.C.A.N. 6505, 6511.

[58] *Busy Beaver Bldg. Ctrs.*, 19 F.3d at 840-42 (3rd Cir. 1994). The *Busy Beaver* court stated that the court has a duty to review fee applications even absent objections by the U.S. Trustee or parties in interest. *Id.* at 841. *See also In re* Miami Optical Export, Inc., 101 B.R. 383, 384 (Bankr. S.D. Fla. 1989) ("The absence of objections [to a fee application] is not evidence of value and affects in no way the court's duty to examine carefully all bankruptcy fee applications to prevent excessive charges.") (citations omitted).

Courts must review the application and rarely will anyone raise an objection. *In re* Nor-les Sales, Inc., 32 B.R. 900, 902 (Bankr. E.D. Mich. 1983) (citing *In re* Kentucky Elec. Power Corp., 11 F. Supp. 528, 530 (W.D. Ky. 1935)). The lack of objection is based partly on the fact that the Bankruptcy Bar is a tightly-knit society and such a small "association fosters a club atmosphere which militates against effective client representation in matters relating to compensation." *Norles*, 32 B.R. at 902 (quoting *In re* Hamilton Hardware Co., 11 B.R. 326, 330 n.1 (Bankr. E.D. Mich. 1981)). Therefore, "the ultimate responsibility to assure that fees do not exceed the bounds of reasonableness rests, as it must, with the court." *Id.*

[59] *Busy Beaver*, 19 F.3d at 841 (citing 11 U.S.C.A. § 105(a) (1993). *See also In re* Martin, 817 F.2d 175, 180 (1st Cir. 1987) (referring to "bankruptcy court's fundamental responsibility to monitor the integrity of the proceedings before it"); *In re* Wonder Corp. of Am., 82 B.R. 186, 191 (D. Conn. 1988)(recognizing "over-arching policy of avoiding the waste of the debtor's estate").

> recognition that a bankruptcy judge, before a fee application is approved, is obligated to [review it carefully] and find it personally acceptable, irrespective of the (always welcomed) observation of the [United States trustee] or other interested parties.[60]

In light of the scrutiny courts must give applications, it is important for the applicant to carefully comply with the technical requirements for applications. The application itself must state the services rendered, the time expended, the expenses incurred and the total amount requested.[61] Additionally the application must contain a

> statement as to what payments have theretofore been made or promised to the applicant for services rendered or to be rendered in any capacity whatsoever in connection with the case, the source of the compensation so paid or promised, whether any compensation previously received has been shared and whether an agreement or understanding exists between the applicant and any other entity for the sharing of compensation received or to be received for services rendered in or in connection with the case, and the particulars of any sharing of compensation or agreement or understanding therefor.[62]

Without compliance with the express requirements of the Rules, some courts have found that a final order approving compensation and reimbursement cannot be entered even if the amounts requested appear reasonable.[63]

Also, Federal Rule of Bankruptcy Procedure 2002(a)(7) requires not less than 20 days notice to creditors and parties in interest of the hearing set to consider an application if the amount requested is greater than $500.00.[64] However, courts

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[60] *Busy Beaver*, 19 F.3d at 841 (quoting *In re* Evans, 153 B.R. 960, 968 (Bankr. E.D. Pa. 1993)) (alterations in original).

[61] FED. R. BANKR. P. 2016(a). *See supra* note 39 for full text of the rule.

[62] FED. R. BANKR. P. 2016(a). *See supra* notes 40-43 and accompanying text for additional analysis.

[63] *In re* Orris, 166 B.R. 935, 938 (Bankr. W.D. Wash. 1994).

[64] FED. R. BANKR. P. 2002(a)(7).

may reduce this time period pursuant to Federal Rule of Bankruptcy Procedure 9006(c)(1).[65]

2. Statutory Factors of Reasonableness Under 330(a)(3).

The most fundamental requirement for compensation under Section 330 is that the compensation be reasonable for "actual, necessary services."[66] The reasonableness is determined in light of the nature, the extent and value of the services.[67] The Bankruptcy Reform Act amended section 330 and now contains a list of relevant factors a court should consider.[68] These factors are only "relevant" because "no matter how close the court comes to an objective determination of a reasonable fee, it is still, in the final analysis, a substantially subjective exercise of the highest degree."[69] Amended Section 330(a)(3) provides the following factors:

> (A) the time spent on such services;
> (B) the rates charged for such services;
> (C) whether the services were necessary to the administration of, or beneficial at the time at which the service was rendered toward the completion of, a case under this title;
> (D) whether the services were performed within a reasonable amount of time commensurate with the complexity, importance and nature of the problem, issue, or task addressed; and
> (E) whether the compensation is reasonable based on the customary compensation charged by comparably skilled practitioners in cases other than cases under this title.[70]

Amended section 330 specifically denies compensation for "unnecessary duplication of services,"[71] and services that "were

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[65] FED. R. BANKR. P. 9006(c)(1).
[66] 11 U.S.C. § 330(a)(1)(A).
[67] *Id.* § 330(a)(3) (1994).
[68] *Id.* § 330(a)(3)(A)-(E).
[69] *In re* Garland Corp., 8 B.R. 826, 831 (Bankr. D. Mass. 1981) (citing *In re* Urban Am. Dev. Co., 564 F.2d 808 (8th Cir. 1977).
[70] 11 U.S.C. § 330(a)(3)(A)-330(a)(3)(E) (1994).
[71] *Id.* § 330(a)(4)(A)(i).

not reasonably likely to benefit the debtor's estate; or necessary to the administration of the case."[72]

Prior to the Bankruptcy Reform Act, the courts determined compensation under Section 330(a) "based on the nature, the extent, and the value of such services, the time spent on such services, and the cost of comparable services other than in a case under [the Code]."[73] These amendments to Section 330(a) do not really change the existing state of the law as most of the elements listed in amended section 330(a) were already being applied by the courts.[74] Prior to the 1994 amendments the courts usually considered the following various factors:

1. The time and labor required.
2. The novelty and difficulty of the questions.
3. The skill requisite to perform the legal service properly.
4. The preclusion of other employment.
5. The customary fee.
6. Whether the fee is fixed or contingent.
7. Time limitations imposed by the and other factors.
8. The amount involved and the results obtained.
9. The experience, reputation and ability of the attorneys.
10. The undesirability of the case.
11. The nature and length of the professional relationship with the client.
12. Awards in similar cases.[75]

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[72] *Id.* § 330(a)(4)(A)(ii)(I) & (II) (1994).

[73] *Id.* § 330(a)(3)(A) (1994).

[74] *See infra* note 75 and accompanying text.

[75] Johnson v. Georgia Highway Express, Inc., 488 F.2d 714, 717-19 (5th Cir. 1974). The *Johnson* court set forth the factors a court should consider when awarding fees in cases under the Civil Rights Act. *Johnson*, 488 F.2d at 717-19. *See also In re* First Colonial Corp. of Am., 544 F.2d 1291, 1298-99 (5th Cir. 1977) (reiterating the twelve factors). For other cases employing the "twelve factors" when determining an award of attorney's fees, see Norman v. Housing Auth., 836 F.2d 1292 (11th Cir. 1988); *In re* U.S. Golf Corp., 639 F.2d 1197 (5th Cir. 1981).

In the *Johnson* case, the Fifth Circuit did not detail the weight courts should place on each of the factors. However, in Copper Liquor, Inc. v. Adolph Coors Co., 624 F.2d 575, 583 (5th Cir. 1980), the Fifth Circuit found that the following factors should be given greater weight when determining an attorney's fee in a bankruptcy case: (1) the time and labor required; (2) the usual fee; (3) the amount involved and the results obtained; and (4) the experience and reputation of counsel.

Some courts have applied these factors to determine reasonableness, others apply a "lodestar" analysis, and others use a "synthesis approach," by applying a combination of the lodestar analysis and *Johnson* factors.[76] Regardless of the nomenclature of a court's analysis, the listing in 330 is not all inclusive, therefore, courts can still and do consider factors set out in *Johnson*, as well as other appropriate factors.

However, at least one commentator has argued that perhaps the listing will in effect be a change in the law because it may lead to a return to the "economy of administration standard."[77] Prior to the Bankruptcy Act of 1978, the primary focus for determining an award of compensation was "economy of administration and conservation of estate."[78] Under this standard, courts set attorney's fees based on notions of equity and fairness to creditors and conservation of the estate.[79] The reasoning was that professionals employed under section 240 of the Bankruptcy Act were "public officers" and were thus not permitted to be compensated on the same scale as those privately employed.[80] Thus, bankruptcy judges were to award fees "at the low end of the spectrum of reasonableness."[81] This in turn led to a perceived stigma that "only less qualified counsel in the bankruptcy bar worked for debtors due to the reduced compensation."[82]

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[76] Donna M. Quinn, *Section 330-Professional Compensation and the Effects of the 1994 Bankruptcy Reform Act*, NORTON ANNUAL SURVEY OF BANKRUPTCY LAW, 340, 344-47 (1996-97 ed.).

[77] K. Shapiro & N. Peterman, 1995 NORTON BANKR. L. ADVISOR, Iss. No. 2, 7 (Feb. 1995).

[78] *In re* River Landings, Inc., 180 B.R. 701, 704 n.4 (Bankr. S.D. Ga. 1995) (citing *In re* Manoa Fin. Co., 853 F.2d 687, 689 (9th Cir. 1988)). *See also In re* Farley, Inc., 156 B.R. 203, 210 (Bankr. N.D. Ill. 1993) (noting that before enactment of Bankruptcy Code, economy of administration was primary consideration in determining attorney fee awards).

[79] *In re* Hunt's Health Care, Inc., 161 B.R. 971, 975 n.1 (Bankr. N.D. Ind. 1993).

[80] *River Landings*, 180 B.R. at 704 n.4 (citing *In re* Manoa Fin. Co., 853 F.2d 687, 689 (9th Cir. 1988)).

[81] *Farley*, 156 B.R. at 210 (quoting *In re* First Colonial Corp. of Am., 544 F.2d 1291, 1299 (5th Cir. 1977)).

[82] *Hunt's Health Care, Inc.*, 161 B.R. at 975 n.1 (citing *In re* Drexel Burnham

In 1978, Congress enacted 11 U.S.C. § 330(a) and expressly provided that compensation should be reasonable and at least in part based on "the cost of comparable services."[83] Congress rejected the "economy of the estate" standard, although the legislative history regarding their retention is somewhat unclear when not read in its entirety.[84] By so rejecting, section

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Lambert Group, Inc., 133 B.R. 13, 17-19 (Bankr. S.D.N.Y. 1991)).

[83] 11 U.S.C. § 330(a)(1) (1982).

[84] *In re* UNR Indus., Inc., 986 F.2d 207, 208-09 (7th Cir. 1993). The *UNR* court stated:

> In enacting section 330, Congress intended to move away from doctrines that strictly limited fee awards under section 241 [of the Bankruptcy Act of 1898] . . . In section 330 and its legislative history Congress expressed its intent that compensation in bankruptcy matters be commensurate with the fees awarded for comparable services in non-bankruptcy cases."

UNR, 986 F.2d at 208-09.

The Third Circuit recognized this and stated that "[v]estiges of this principle [economy of the estate] are found in the Senate Committee on the Judiciary's Report accompanying the pre-conference version of the 1978 amendments." *In re* Busy Beaver Bldg. Ctrs., 19 F.3d 833, 850 (3d Cir. 1994). The reporter provided:

> [E]conomy in administration is the basic objective . . . . The reference to "the cost of comparable services" in a nonbankruptcy case [in § 330] is not intended as a change of existing law. In a bankruptcy case fees are not a matter for private agreement. There is inherent a "public interest" that "must be considered in awarding fees." (citation omitted). An allowance is the result of a balance struck between moderation in the interest of the estate and its security holders and the need to be "generous enough to encourage" lawyers and others to render the necessary and exacting services that bankruptcy cases often require [citation omitted]. The rates for similar kinds of services in private employment is one element, among others, in that balance. Compensation in private employment noted in subsection (a) is a point of reference, not a controlling determinant of what shall be allowed in bankruptcy cases.

S. REP. NO. 95-989 at 40 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5707, 5826.

However, the Joint Explanatory Statement read by the respective floor managers in each chamber of Congress provides clear guidance that the "economy of the estate" approach was rejected. The statement reads:

> Section 330(a) contains the standard of compensation adopted in H.R. 8200 as passed by the House rather than the contrary standard contained in the Senate amendment . . . .[B]ankruptcy legal services are entitled to command the same competency of counsel as other cases. In that light, the policy of this section is to compensate attorneys and other professionals serving in a case under title [11] at the same rate as the

330 now serves two important purposes: (1) compensation be fair and reasonable, and not deter "competent counsel from entering the bankruptcy area;" and (2) "attorneys should receive in bankruptcy matters what they would receive on the open market."[85]

It is argued that the 1994 amendment to 11 U.S.C. § 330, which makes the "cost of comparable services" standard one of five nonexclusive facts, may return courts to apply an economy of administration standard.[86] Prior to the 1994 amendments, the "cost of comparable services" was one of very few factors courts would not give due consideration and possibly apply the economy of administration standard.[87] It is unlikely the amendment will work any real change in how courts are analyzing the reasonableness of a fee application. Amended section 330 does include a nonexclusive list of factors to consider which includes the cost of similar services. Likewise, the pre-1994 amendment section 330 was not expressly limited to the factors listed therein. A careful reading indicates other factors may be considered and in fact courts have developed approximately twelve factors. Implicit within any "reasonable" award under 330(a) is a careful evaluation of numerous factors. The nonexclusive listing will likely not change current procedures in awarding compensation.

> attorney or other professional would be compensated for performing comparable services other than in a case under title [11]. Contrary language in the Senate report accompanying S. 2266 is rejected, and *Massachusetts Mutual Life Insurance Company v. Brock*, 405 F.2d 429, 432 (5th Cir. 1968) is overruled. Notions of economy of the estate in fixing fees are outdated and have no place in a bankruptcy code.

124 CONG. REC. 33, 994 (1978) (Joint Explanatory Statement) (remarks of Sen. DeConcini) (emphasis added), reprinted in 1978 U.S.C.C.A.N. 6505, 6511.

[85] *Hunt's Health Care*, 161 B.R. at 975 (citing *In re* UNR Indus., Inc., 986 F.2d 207, 209 (7th Cir. 1993)). *See also In re* Nor-les Sales, Inc., 32 B.R. 900, 902 (Bankr. E.D. Mich. 1983) ("The compensation awarded should be adequate to provide an incentive for competent and able lawyers to participate in bankruptcy proceedings and to insure efficient case administration.").

[86] Shapiro & Peterman, *supra* note 76.

[87] *Id.*

3. Express Statutory Limitations of Reasonableness.

Just as the listing of factors will not likely work a change in the law, the express limitations provided by the Reform Act will also not have any great effect on the law. First, the Section 330(a)(4)(A)(i) limit on duplication of services is implicit in any fees award that is reasonable and was already a basis for limitation of awards in cases such as *In re Affinito & Son, Inc.*,[88] where the court denied compensation for accountants and attorneys of the debtor because the fee application contained duplicative entries.[89]

Secondly, the 1994 amendments limit to services which are "reasonably likely to benefit the debtor's estate"[90] will likely not make a change in the law.[91] Prior to the 1994 amendments, the great weight of authority found that benefit to the estate was necessary for an attorney to receive an award of compensation.[92] Awards of compensation will not be allowed if

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[88] 63 B.R. 495 (Bankr. W.D. Pa. 1986). *See also In re* Ginji Corp., 117 B.R. 983, 993 (Bankr. D. Nev. 1990) (disallowing expenses and fees of two attorneys who went to hearing without showing they were both needed); *In re* Wonder Corp. of Am.), 82 B.R. 186, 192 (D. Conn. 1988) (holding that unreasonable duplication of services meant to frustrate proceedings justifies reduction of award); *In re* Sapolin Paints, Inc., 38 B.R. 807, 814-15 (Bankr. E.D.N.Y. 1984) (reducing award where services were duplicated because of joint representation by two firms of same creditor's committee).

[89] *Affinito & Son, Inc.*, 63 B.R. at 498.

[90] 11 U.S.C. § 330(a)(4)(A)(ii)(I) (1994).

[91] *See, e.g., In re* Spanjer Bros., Inc., 191 B.R. 738, 748 (Bankr. N.D. Ill. 1996) ("The amendment of the Bankruptcy Code to account for professionals' performance of administrative functions which might have no direct quantifiable benefit . . . did not alter the principle that compensable services must have been rendered for the estate's benefit.").

[92] *See In re* Lederman Enters., Inc., 997 F.2d 1321, 1323 (10th Cir. 1993); *In re* Reed, 890 F.2d 104, 105 (8th Cir. 1989); *In re* Hanson, 172 B.R. 67, 70 (B.A.P. 9th Cir. 1994); *In re* Grimm, 156 B.R. 958, 961 (Bankr. E.D. Va. 1993); *In re* Peter J. Schmitt Co., 154 B.R. 632, 637 (Bankr. D. Del. 1993); *In re* Kingsburry, 146 B.R. 581, 585 (Bankr. D. Me. 1992); *In re* Greene, 138 B.R. 403, 408 (Bankr. S.D.N.Y. 1992); *In re* Office Prods. of Am., Inc., 136 B.R. 983, 988 (Bankr. W.D. Tex. 1992). One court aptly noted that "[to] allow a debtor to dissipate the estate by paying attorney fees for services of no benefit to the estate is contrary to the concept of equitable distribution of the estate." *In re* Latham, 131 B.R. 238, 239 (Bankr. S.D. Fla. 1991). *See also* Grant v. George Schumann Tire & Battery Co., 908 F.2d 874, 883 (11th Cir. 1990) (holding attorney for trustee could not be paid

the services do not benefit the estate, even if they benefit the debtor.[93] The distinction lies between those services that "ben-

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for defending debtor's appeal of award since those services did not benefit estate).

Prior to the 1994 amendments, a minority of cases held that services which did not "benefit the estate" were nevertheless compensable. *See In re* Deihl, 80 B.R. 1 (Bankr. D. Me. 1987); *In re* Gray, 7 Collier Bankr. Cas. (MB) 571 (Bankr. D. Me. 1975). Substantively, both cases involved the compensation of debtor's counsel in defending dischargeablity actions in consumer, non-business, Chapter 7 cases. The weight of these cases is questionable because a later decision from the same court analyzed those decisions and found that such services were not compensable. *In re* Kingsburry, 146 B.R. 581, 585 (Bankr. D. Me. 1992). Other courts criticized the holdings of *Gray* and *Deihl* and characterized the cases as "a splinter of authority." *In re* Holden, 101 B.R. 573, 575 (Bankr. N.D. Iowa 1989).

The problem with the minority view is that the cases are based on pre-Code law. *Kingsbury*, 146 B.R. at 582. Under Bankruptcy Act § 64(a)(1) [11 U.S.C. § 330's predecessor], priority claims included the "cost and expenses of administration" which included reasonable attorney fees for services rendered to the debtor. Thereupon, the *Gray* court created a rule "approving compensation to debtor's counsel for services rendered in carrying out the provision of the Bankruptcy Act which did not hinder the administration of the case." *Kingsbury*, 146 B.R. at 582 (citing *In re* Gray, 7 Collier Bankr. Cas. (MB) 571, 580, 583 (Bankr. D. Me. 1975). As the Bankruptcy Act did not forbid payment of a debtor's attorney's fees in dischargeablity actions (services which do not benefit the estate), the *Grey* court considered the payment of such services a policy question and noted the great importance of providing debtors a "fresh start" through a decree of discharge. *Id.* The *Gray* court was concerned with the "meaningful possibility that default judgments might be entered against debtors unable to afford to retain counsel." *Id.* at 583. The *Deihl* court followed *Gray* without considering the great weight of cases decided under 11 U.S.C. § 330 that found a benefit to the estate was necessary in order for a debtor's attorney to be compensated under that provision. Furthermore, Congress has provided a mechanism for creditors to contribute to the compensation of a consumer debtor's counsel in unsuccessful dischargeability actions. 11 U.S.C. § 523(d) provides:

> If a creditor requests a determination of dischargeability of a consumer debt under subsection (a)(2) . . . , and such debt is discharged, the court shall grant judgment in favor of the debtor for the costs of, and a reasonable attorney's fee for, the proceeding if the court finds that the position of the creditor was not substantially justified, except that the court shall not award such costs and fees if special circumstances would make the award unjust.

11 U.S.C. § 523(d) (1994). The 1994 amendments, expressly providing for the denial of an award of compensation if the services were not for the benefit of the estate, certainly overrule the minority view and will eliminate the possibility of decisions such as *Deihl*.

[93] *In re* Barrie-Reed Buick-GMC, Inc., 164 B.R. 378, 381 (Bankr. S.D. Fla. 1994). The *Barrie-Reed* court stated that "[p]rofessionals employed by a debtor are

efit the estate and those that benefit only the debtor."[94] However, the benefit of the estate does not need to be direct[95] or necessarily even a monetary benefit.[96] Generally, if the services aid the administration of the estate, they are considered a benefit to the estate.[97] Judge Barliant, in *In re Lifschutltz Fast Freight, Inc.*,[98] thoughtfully recognized that "the concept of benefit to the estate is not necessarily limited to an economic approach along the line that a dollar's worth of services must directly benefit the estate and bring a cash dollar into the estate in order to justify allowance of one dollar cash compensation."[99]

The basis for courts prior to the 1994 amendments requiring a benefit to the estate was premised on the argument that the "benefit of the estate doctrine" was established under the Bankruptcy Act and when Congress added § 330(a) in the Bankruptcy Code there was no evidence that Congress intend-

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entitled to compensation from the bankruptcy estate only if the services rendered were of a value to the administration of the estate or for its benefit." *Barrie-Reed*, 164 B.R. at 381 (citing *In re* Sandra Cotton, Inc., 91 B.R. 657 (W.D.N.Y. 1988)). *See also In re* Brandenburger, 145 B.R. 624, 628 (Bankr. D.S.D. 1992) ("Services that benefit only the debtor are not compensable from the estate.") (citing *In re* Reed, 890 F.2d 104, 106 (8th Cir. 1989)).

[94] *Brandenburger*, 145 B.R. at 628 (Bankr. D.S.D. 1992).

[95] *See In re* DN Assocs. 3 F.3d 512 (1st Cir. 1993). In *DN Assocs.*, the debtor's counsel proposed three different plans and eventually a creditor's plan was confirmed. The court found that the debtor's plans provoked the creditor to propose his own plan and thus lead to a confirmable plan, a benefit to the estate. *DN Assocs.*, F.3d at 516-17. *See also In re* Lederman Enters., Inc., 143 B.R. 772, 775 (D. Colo. 1992) (holding appropriate court's denial of fees where no benefit accrued to subsequent litigation), *aff'd*, 997 F.2d 1321 (10th Cir. 1993).

[96] *Brandenburger*, 145 B.R. at 628 (citing *In re* Reed, 890 F.2d 104, 105-06 (8th Cir. 1989)). The court made note of the fact that prior cases have not limited "benefit to the estate" to monetary benefit." *Brandenburger*, 148 B.R. at 629.

[97] *See In re* Latham, 131 B.R. 238 (Bankr. S.D. Fla. 1991); *In re* Marker, 100 B.R. 569, 571 (Bankr. N.D. Ala. 1989).

[98] 140 B.R. 482, 488 (Bankr. N.D. Ill 1992).

[99] *In re* Spanjer Bros., Inc., 191 B.R. 738, 748 (Bankr. N.D. Ill. 1996) (citing *Lifschutltz Fast Freight, Inc.*, 140 B.R. at 488)). The *Spanjer Bros.* court concurred with Judge Barliant because "the bankruptcy estate does not exist merely for esoteric purposes, but rather, serves as a fund from which allowed claims are to be paid in the order and priority established under the Bankruptcy Code." *Spanjer Bros.*, 191 B.R. at 748.

ed to modify this reasoning when enacting 330(a).[100] Other courts argued that the "benefit to the estate" was subsumed by section 330(a)'s (pre-1994 amendment) requirement that compensation be "reasonable compensation for actual, necessary services."[101]

Regardless of the basis for the pre-1994 Reform Act court decisions requiring benefit to the estate, the rationale behind requiring a benefit to the estate is well grounded and is perhaps best stated as follows:

> Providing debtors in certain circumstances with an opportunity for a fresh start is certainly a goal of the Code, which is financed, albeit, less than willingly, by creditors who, generally must accept less than 100 cents on every debt dollar. But fairness, too, is a Code value. And, requiring a showing of some benefit to the estate as a predicate to a § 330(a) fee award strikes the right balance between the goal of providing a fresh start and fairness.[102]

Because the 1994 Reform Act explicitly requires a benefit to the estate, it reinforces several public policies of the Bankruptcy Code, including equitable distribution of assets, fairness, and providing a fresh start for the debtor.

Similarly, the limitation of compensation for services unnecessary for the administration of the estate in amended section 330(a)(4)(A)(ii)(II) is already considered by courts because the pre-1994 amendment section 330(a)(1) stated that compensation could be awarded for "necessary services." Note that under amended section 330(a)(3)(C), whether the services were necessary to the estate's administration is already considered by courts in determining fee awards. Thus, the amended provi-

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[100] *Brandenburger*, 145 B.R. at 628 (citing *In re* Ryan, 82 B.R. 929, 932 (N.D. Ill. 1987)).

[101] *Brandenburger*, 145 B.R. at 628-29 (citing *In re* Lifschultz Fast Freight, Inc., 140 B.R. 482, 485-86 (Bankr. N.D. Ill. 1992)). Neither the *Lifschultz* or *Ryan* court limited "benefit to the estate" to monetary benefit. *Id.* at 629.

[102] *In re* Grimm, 156 B.R. 958, 962 (E.D. Va. 1993). The court determined that the debtor's efforts to defend against allegations of misconduct did not benefit the estate. *Grimm*, 156 B.R. at 962.

sion expressly approves the denial of fees not necessary for the administration of the estate.[103] For example, an attorney will not be compensated for time spent on acquainting himself with the basic provisions of Title 11.[104] Similarly other professionals, such as accountants, will not be compensated for time spent on research of basic bankruptcy tax issues.[105]

The 1994 Reform Act added subsection (6) to 330(a).[106] This subsection is not a limit on compensation but dictates that applicants use "billing judgment"[107] in regard to compensable time spent on fee applications. The section clarifies a split of authority regarding whether the time spent in preparing a fee application was compensable under Section 330.[108] Subsection (6) provides that a reasonable amount of time spent preparing a fee application is compensable.[109]

Most nonbankruptcy attorneys usually do not charge their clients for time spent preparing the client's bill because such

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[103] *In re Lederman Enters., Inc.*, 997 F.2d 1321, 1323-24 (10th. Cir. 1993). The *Lederman* court commented:

> [The law firm] was not denied fees as a penalty, . . . but because its services were unnecessary. . . [T]he debtor's inability to successfully develop and complete a plan should have been apparent to counsel from commencement of the case. Therefore, any work performed by [the law firm] was not necessary, and the bankruptcy court did not abuse its discretion in refusing to compensate the law firm for such services."

Lederman, 987 F.2d at 1323-24.

[104] *In re* St. Pierre, 4 B.R. 184, 186 (Bankr. D.R.I. 1980). The court determined that reviewing the code was a cost of doing business. *St. Pierre*, 48 B.R. at 186. *See also In re* Rivers, 167 B.R. 288 (Bankr. N.D. Ga. 1994) (stating that incompetent or unqualified attorney is not entitled to payment from estate); *In re* Wire Cloth Prods., Inc., 130 B.R. 798, 813 (Bankr. N.D. Ill. 1991) (holding that research into generally known rules of law was not compensable).

[105] *In re* Chas. A. Stevens & Co., 109 B.R. 853, 856 (Bankr. N.D. Ill. 1990). *See also In re* Gold Seal Prods. Co., Inc., 128 B.R. 822 (Bankr. N.D. Ala. 1991) (holding accountants to same standards as attorneys).

[106] 11 U.S.C. §330(a)(6) (1994). That section provides: "Any compensation awarded for the preparation of a fee application shall be based on the level and skill reasonably required to prepare the application." 11 U.S.C. § 330(a)(6) (1994).

[107] *See infra* notes 114-29 and accompanying text.

[108] *Compare, e.g., In re* Nucorp Energy, Inc., 764 F.2d 655, 658-59 n.4 (9th Cir. 1985) (holding preparation time compensable) *with, e.g., In re* Central R.R., 477 F. Supp. 1228, 1233 (D.N.J. 1979) (holding preparation time not compensable).

[109] 11 U.S.C. § 330(a)(6) (1994).

work is not performed on behalf of the client.[110] Prior to the Bankruptcy Reform Act, some courts held that fee petition preparation time was not compensable for that very reason.[111] However, Congress, as well as numerous courts, found that the better view was to allow professionals compensation for time reasonably spent preparing fee applications.[112] The policy behind this rationale was that "[i]f compensation for preparation of fee applications were disallowed, professionals would have little incentive to engage in a comprehensive review of the time expended and the value thereof. Moreover, debtors would be deprived of any discount which might flow from a close scrutiny of the time performed."[113]

But there are limits on the amount of time an attorney can be compensated for preparing a fee application. Quite often applicants manage their time poorly by neglecting to categorize their time by activity, asking ten to fifteen percent of the total request merely to prepare the application.[114] Such disproportionate applications will likely be disallowed as will fees for inadequate applications. Absent unusual circumstances, some courts have limited compensable hours for preparing and litigating attorney fee applications to no greater than three percent of the total hours in the case.

4. The Implicit Limitation of Reasonableness: "Billing Judgment."

Whether courts set forth the *Johnson* factors or rely on the language set forth in section 330 to determine reasonableness,

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[110] *In re* Pettibone Corp. 74 B.R. 293, 304 (Bankr. N.D. Ill. 1987). The court determined that reasonable compensation should be permitted to professionals for time spent preparing fee applications. *Pettibone*, 75 B.R. at 304.

[111] *Pettibone*, 74 B.R. at 304 (citing See, e.g., In re Wilson Foods Corp., 36 B.R. 317, 323 (Bankr. W.D. Okla. 1984)).

[112] *Id.* (citing *In re* Jensen-Farley Pictures, Inc., 47 B.R. 557, 583 (Bankr. D. Utah 1985)).

[113] *Id.* (citing *In re* NuCorp Energy, Inc., 764 F.2d 655, 658-59 (9th Cir.1985). *See also In re* Vlachos, 61 B.R. 473, 481 (Bankr.S.D.Ohio 1986)) (holding time spent preparing fee applications compensable if unnecessary time discounted).

[114] *Pettibone*, 74 B.R. at 304.

one underlying principle is found in all determinations of the reasonableness of fee applications. This is referred to as the concept of "billing judgment." The United States Supreme Court articulated this concept early on in *Hensley v. Eckerhart*,[115] a nonbankruptcy matter, where the Court stated as follows concerning attorneys applying for statutory attorney's fees:

> [Such attorneys] should make a good faith effort to exclude from a fee request hours that are excessive, redundant, or otherwise unnecessary just as a lawyer in private practice ethically is obligated to exclude such hours from his fee submission. "In the private sector, 'billing judgment' is an important component in fee setting. It is no less important here."[116]

Bankruptcy Courts have long recognized that the standard for compensation set forth in Section 330 makes the exercise of such "billing judgment" a mandatory requirement in bankruptcy fee matters, whether the courts expressly used the phrase "billing judgment" or not.[117] As the Bankruptcy Court for the

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[115] 461 U.S. 424 (1983).

[116] *Hensley*, 461 U.S. at 434 (quoting Copeland v. Marshall, 641 F.2d 880, 891 (D.C. Cir. 1980) (en banc)).

[117] *In re* Pettibone Corp. 74 B.R. 293, 303 (Bankr. N.D. Ill 1987). *See also In re* Spanjer Bros., Inc., 191 B.R. at 748-49, where the court stated as follows:

> The Court may determine what is the reasonable amount of time a professional should have to spend on a given project. (citation omitted). Professionals will not be rewarded for inefficiency, nor fully compensated for spending an unreasonable amount of time on activities of little benefit to the estate.

The Supreme Court in *Hensley v. Eckerhart* ruled that "excessive, redundant or otherwise unnecessary" hours should be excluded from the fees sought. In other words, applicants should exercise good faith "billing judgment." *Hensley v. Eckerhart*, 461 U.S. 424 (1983) (citations omitted).

> Reasonable time spent does not necessarily include all time actually expended. Hence, the exercise of good faith billing judgment comes into play. Compensation will not be awarded for nonproductive time, or for time spent on services that are duplicative of previously rendered services. Duplication of services constitutes an unreasonable expenditure of time and therefore is noncompensable. In determining what constitutes reasonable compensation, the Seventh Circuit has stated that "there are

Northern District of Illinois stated, the bankruptcy estate "should not bear the burden of a duplication of services, and such duplication should be avoided by counsel on their own initiative by exercise of good "billing judgment."[118]

Courts have recognized numerous limitations which fall under the discretion the applicant and court must apply in consideration of proper "billing judgment." These include the following:

(a) Individual Responsibility.[119]

As a general rule, attorneys should work independently and not confer needlessly with other attorneys.[120] Also, only one attorney ought to charge for attendance at an office meeting.[121] Two types of work for which only one attorney should be compensated are court appearances[122] and depositions.[123]

(b) Appropriate Level of Skill.

Higher partner rates will be paid only for work warranting the attention of a senior partner, because a senior partner who performs simple tasks more appropriate for a new associate should be paid at the lower rate.[124] Like-

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limits—measured by standards of reasonableness—to what a professional can demand in a bankruptcy case. (citations omitted).

Spanjer, 191 B.R. at 748-49.

[118] *Pettibone*, 74 B.R. at 303.

[119] *Id.*

[120] *Id.*

[121] *Id.* (citing *In re* R & B Inst'l Sales, Inc., 65 B.R. 876, 882 (Bankr. W.D. Pa. 1986).

[122] *Id.* (citing *In re* Jensen-Farley Pictures, Inc., 47 B.R. 557, 583 (Bankr. D. Utah 1985). Counsel who do not participate in motions or arguments should not apply for fees if they did not contribute. *Jensen*, 47 B.R. at 583. In addition, attorneys should not bypass this requirement by simply rotating or taking turns participating at court appearances. *Pettibone*, 74 B.R. at 303 (citing *In re* Holthoff, 55 B.R. 36, 40 (Bankr. E.D. Ark. 1985)).

[123] *Pettibone*, 74 B.R. at 303. "Absent special circumstances, one attorney is sufficient to handle any depositions." *Id.* (citing *In re* Continental Ill. Sec. Litig., 572 F. Supp. 931, 933 (N.D. Ill. 1983)).

[124] *Id.* (citing *Continental Ill. Sec. Litig.*, 572 F. Supp. at 933).

wise, lawyers will be paid less for non-legal work.[125]

(c) Legal Research.

Courts generally recognize that particular issues requiring research arise from time to time.[126] However, fees for general research on well-known law will be disallowed.[127]

(d) Document Review.

Reading the work product of another lawyer simply for recreation is not compensable unless helpful in some way to the case at hand.[128]

(e) Routine Services.

Courts have sometimes held that routine services like telephone calls and correspondence should be compensated at a lower rate than more professional services like litigation, research and document drafting.[129] Other courts have found that the distinction between these services is benign and discourages non-legal methods of resolving disputes.[130]

B. The Attorney Must Comply with the Application Requirements Mandated by Federal Rule of Bankruptcy Procedure 2014(a).

If an attorney never obtains court approval of his or her employment by the estate, they will likely be denied compensation. [131] In *In re Samford*,[132] the attorney for the debtor-in-

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[125] *Id.* (citing *Jensen-Farley*, 47 B.R. at 583). The Code encourages lawyers to use paralegals for efficiency and cost effectiveness. 11 U.S.C. § 330(a)(1) (1994).

[126] *Pettibone*, 74 B.R. at 303.

[127] *Id.* (citing *Continental Ill. Sec. Litig.*, 572 F. Supp. at 933).

[128] *Id.*

[129] *In re* Ferkauf, Inc., 42 B.R. 852, 858 (Bankr. S.D.N.Y. 1984).

[130] *Pettibone*, 74 B.R. at 404 (citing *Jensen-Farley*, 47 B.R. at 584).

[131] *In re* Occidental Fin. Group, Inc., 40 F.3d 1059 (9th Cir. 1994). In *Occidental*, the attorney was denied compensation when he failed to obtain prior court approval. *See also In re* Shirley, 134 B.R. 940, 943 (B.A.P. 9th Cir. 1992) (stating

possession was found to not be entitled to compensation where he was not approved by the bankruptcy court and in fact the attorney never complied with the title 11 provision regarding appointment of an attorney for the debtor-in-possession.[133] The Ninth Circuit denied a real-estate broker his commission on the sale of the debtor-in-possession's real estate because the broker, a professional subject to 327(a), did not obtain court authorization prior to employment under 11 U.S.C. § 327(a).[134] There are numerous other cases where the court has denied compensation for failure of other professionals such as architects[135] or management consultants[136] to obtain court authorization prior to employment.

The problem with failing to obtain court approval is that there is no other way to assure that the very important purposes of Rule 2014(a) can be served. In *In re Haley*,[137] the Ninth Circuit enunciated the basis for prior approval as follows: "The purpose of the rule requiring prior court authorization of a professional's appointment is to eliminate volunteerism and thus aid the court in controlling estate administrative expenses."[138]

The same problem exists when an attorney or professional makes application for employment and a period of time has

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that court approval is *sine qua non* of attorney compensation). Ibbetson v. U.S. Trustee, 100 B.R. 548 (D. Kan. 1989) (stating that to be compensated from bankruptcy estate, court must approve attorney's employment).

[132] 125 B.R. 230, 233 (E.D. Mo. 1991).

[133] *Samford*, 125 B.R. at 233.

[134] *In re* Cummins, 8 B.R. 701, 702 (Bankr. C.D. Cal. 1981), *rev'd on other grounds*, 15 B.R. 893 (B.A.P. 9th Cir. 1981).

[135] *In re* Holiday Mart, Inc., 18 B.R. 212, 216 (Bankr. D.C. Haw. 1982). The *Holiday Mart* court stated that valueless services not approved prior to performance were not compensable. *Holiday Mart*, 18 B.R. at 216.

[136] *In re* WFDR, Inc., 22 B.R. 266, 266 (Bankr. N.D. Ga. 1982). The *WFDR* court denied fees to management consultants who failed to get prior court approval for their employment. *WFDR*, 22 B.R. at 266.

[137] 950 F.2d 588 (9th Cir. 1991).

[138] *Haley*, 950 F.2d at 590 (quoting *In re* Willamette Timber Sys., Inc. 54 B.R. 485, 488 (Bankr. D. Or. 1985)). *See also In re* Eureka Upholstering Co., 48 F.2d 95 (2d Cir. 1931) (noting that court must approve employment to prevent conflicts of interests and manage costs).

passed between when the attorney was retained and when he applied for employment. In these situations, the applicant will seek court approval *nunc pro tunc*,[139] to have the employment approved back to the application so as to include those technically pre-application services for compensation under 330(a). There is no statutory provision which requires pre-approval for employment or forbids retroactive approval of attorneys for the debtor-in-possession.[140] Thus, most courts have found it within their discretion to enter *nunc pro tunc* retention orders.[141] However, there is no absolute right to nunc pro tunc approval.[142] Law firms will need to make specific requests for *nunc pro tunc* employment[143] and a court will only consider it after notice and a hearing.[144]

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[139] *Nunc pro tunc*:

> Now for then . . . a phrase applied to acts allowed to be done after the time when they should be done, with a retroactive effect, *i.e.*, with the same effect as if regularly done. *Nunc pro tunc* entry is an entry made now of something actually previously done to have effect of former date. . . .
>
> *Nunc pro tunc* merely describes inherent power of court to make its records speak the truth, *i.e.*, to court record at a later date to reflect what actually occurred. . . *Nunc pro tunc* signifies now for then, or in other words, a thing is done now, which shall have same legal force and effect as if done at time when it ought to have been done . . .

BLACK'S LAW DICTIONARY 1069 (6th ed. 1990).

[140] *In re* Office Prods. of Am., Inc., 136 B.R. 675, 682 (Bankr. W.D. Tex. 1992) (citing *In re* Twinton Properties Ptrshp., 27 B.R. 817, 819 (Bankr. M.D. Tenn.), *aff'd*, 33 B.R. 111 (1983). *See also* Fanelli v. Hensley, (*In re* Triangle Chems., Inc.), 697 F.2d 1280, 1284 (5th Cir. 1983) (stating that decision to approve *nunc pro tunc* employment is up to court)).

[141] 3 COLLIER ON BANKRUPTCY ¶ 327.03[3], n.11 (Lawrence P. King et al. eds. rev. ed. 1996) (citing *In re* Laurent Watch Co., 539 F.2d 1231 (9th Cir. 1976); Stolkin v. Nachman, 472 F.2d 222 (7th Cir. 1973). *See also In re* Occidental Fin. Group, Inc., 40 F.3d 1059, 1062-63 (9th Cir 1994) (stating that court may occasionally approve employment *nunc pro tunc*); *In re* Inter Urban Broadcasting, Inc., 174 B.R. 441, 448 (E.D. La. 1994) (finding *nunc pro tunc* appointment within court's discretion).

[142] Office Prods. of Am., 136 B.R. at 682 (citing *In re* Kroeger Properties & Dev., Inc., 57 B.R. 821, 822 (B.A.P. 9th Cir. 1986)).

[143] *See, e.g., In re* Southern Diversified Properties, Inc., 110 B.R. 992, 996 (Bankr. N.D. Ga. 1990) (denying fees for law firm).

[144] *In re* Tidewater Mem'l Hosp., Inc., 110 B.R. 221, 225 (Bankr. E.D. Va. 1989).

A wide array of cases involve *nunc pro tunc* retention. If there is a short delay in application for employment after beginning services, usually the attorney will be granted *nunc pro tunc* employment. This involves work done at the initiation of the case, usually preparation work between the genesis of the debtor-attorney relationship and court approval of employment.[145] It is common practice for courts to appoint counsel *nunc pro tunc* for this gap period[146] because it "is nearly impossible to file a retention application and obtain a retention order prior to performing any services."[147] When the gap period is only a few days or weeks, the court will likely appoint counsel without "confronting the issue of *nunc pro tunc* . . . retention."[148] Some courts recognize that some services will be rendered before application can be made and approved. These courts have created an outer limit for a reasonable gap period.[149] For instance, in *In re Martin*,[150] the court found thirty days from the commencement of the case an appropriate outer limit for a reasonable gap period, before obtaining court approval.[151] Beyond this period the burden will be on the attorney to show a reasonable explanation for the delay.[152]

Cases with long delays between rendering services and application cause problems. At some point, the delay in seeking court approval becomes unreasonable and granting *nunc pro tunc* employment will defeat the goals of requiring prior approval of counsel. For example, where an attorney for the debtor-in-possession waited eleven months after beginning work on

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[145] *In re* Urrutia, 137 B.R. 563, 566 (D. Puerto Rico 1990). *See also In re* Gire, 107 B.R. 739, 748-50 (Bankr. E.D. Cal. 1989) (concluding that no *nunc pro tunc* order was necessary for 19.75 hours of services rendered 26 days before approval of employment).

[146] David A. Rosenzweig, *Sections 327-331 Attorney Compensation,* NORTON'S ANNUAL SURVEY OF BANKRUPTCY LAW 297, 298 (1994-95 ed).

[147] *Id.*

[148] *Id.*

[149] *See In re* Martin, 102 B.R. 653, 656 (Bankr. W.D. Tenn. 1989); *In re* Sinor, 18 Collier Bankr. Cas. 2d 1263, 1266 (Bankr. E.D. Cal. 1988).

[150] 102 B.R. 653 (Bankr. W.D. Tenn. 1989).

[151] *Martin*, 102 B.R. at 656.

[152] *Id.*

the case to file application for approval, he was denied compensation even though he had already been representing the debtors.[153] Other cases have involved delays of seven years or more by counsel in requesting appointment.[154]

The difficult cases are those that fall somewhere between the time frame of those already discussed. Generally, retroactive employment will only be approved if (1) the applicant satisfies the disinterestedness requirements of the Code and would have been initially approved by the court; and (2) in the exercise of the court's discretion, the particular circumstances presented are extraordinary enough to warrant retroactive approval.[155] Other courts do not approach the test of *nunc pro tunc* employment as a two prong test, but rather, analyze it using several factors.[156] Regardless of the name of the test, its application is the same because cases which employ a number of factors always include part one of the two prong test as a

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[153] *In re* Mallamaci, 152 B.R. 41, 43 (Bankr. M.D. Pa. 1993).

[154] *In re* Universal Parts & Servs., Inc., 151 B.R. 285, 286-87 (Bankr. W.D. Okla. 1993). *See also In re* Hercules Serv. Corp., 116 B.R. 50 (Bankr. W.D. Pa. 1990) (denying approval of *nunc pro tunc* employment after seven and a half years delay).

[155] *In re Office Prods. of Am., Inc.*, 136 B.R. 675, 683. The *Office Products* court noted:

> At the very lest, a professional seeking *nunc pro tunc* approval of employment must comply with the requirements of § 327; that is, he or she must be a disinterested person and must not hold or represent an interest adverse to the estate. (citations omitted). In addition, some courts have held that because *nunc pro tunc* approval is discretionary and essentially remedial, the bankruptcy court should weigh the equities of the case before granting such approval.

Official Prods. of Am., 136 B.R. at 683. *See also In re* Smith, 125 B.R. 841, 842 (Bankr. M.D. Fla. 1991) (denying *nunc pro tunc* employment of experienced attorney absent extraordinary circumstances); Merchants & Farmers Bank v. Hill, 122 B.R. 539, 544 (E.D. Ark. 1990) (granting *nunc pro tunc* employment when failure to obtain court's approval resulted from time constraints, not neglect); *In re* Wellington Dev., Inc., 119 B.R. 65, 67 (Bankr. W.D. Pa. 1990) (denying *nunc pro tunc* approval when failure to obtain approval was merely oversight).

[156] *See In re* WAPI, Inc., 171 B.R. 130, 133-35 (Bankr. N.D. Ala. 1994) (citing *In re* Office Prods., Inc., 136 B.R. at 683-684). These factors originate from *In re* Williamette Timber Sys., Inc., 54 B.R. 485 (Bankr. D. Or. 1985) and *In re* Twinton Properties, 27 B.R. 817 (Bankr. M.D. Tenn. 1983). *WAPI*, 171 B.R. at 133 n.4.

factor. The remaining factors are simply considerations a court uses in making its purely discretionary decision to grant an application for *nunc pro tunc* employment. These factors essentially present the question of whether there are sufficient extraordinary circumstances to warrant retroactive approval, which is the second prong of the two prong test.

C. The Attorney Must Make a Complete Disclosure at the Time of Application and Such Requirement is Continuing in Nature.

Failure to make a full and complete disclosure is, alone, sufficient grounds to deny compensation to an attorney or any other professional.[157] As one court noted: "Anything less than the full measure of disclosure leaves the counsel at risk that all compensation may be denied."[158] The Eleventh Circuit Court of Appeals relied in part on the lack of disclosure of a law firm and denied the firm compensation of almost $200,000.[159] Other professionals have been denied compensation for failing to make certain disclosures. For example, in *In re Eastern Inns, Inc.*,[160] a real estate broker failed to disclose at the time of appointment that his father and partner was a creditor of the

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[157] *In re* Leslie Fay Cos., Inc., 175 B.R. 525, 533 (Bankr. S.D.N.Y. 1994). The *Leslie Fay* court noted: "So important is the duty of disclosure that the failure to disclose relevant connections is a independent basis for the disallowance or fees or even disqualification." *Leslie Fay*, 175 B.R. at 533. *See also In re* EWC, Inc., 138 B.R. 276, 280 (Bankr. W.D. Okla. 1992) ("Violation of the disclosure rules alone is enough to disqualify a professional and deny compensation."); *In re* Lillian Laurence Ltd., 136 B.R. 1, 6 (Bankr. D. C. 1992) (allowing fees only after which disclosure of dual representation of debtor and debtor's principal); *In re* Plaza Hotel Corp., 882, 886-87 (Bankr. E.D. Ca. 1990) (sanctioning attorney by returning retainer to debtor), *aff'd*, 123 B.R. 466 (B.A.P. 1990); *In re* Robert J. Au & Son, Inc., 71 B.R. 238, 242 (Bankr. N.D. Ohio 1985) (denying as within court's discretion, fees for failing to disclose). For earlier cases where courts denied fees because the attorney failed to make a complete disclosure, see *In re* Thompson, 54 B.R. 311, 317 (Bankr. N.D. Ohio 1985), *aff'd*, 77 B.R. 113 (N.D. Ohio 1987); *In re* Whitman, 51 B.R. 502, 507 (Bankr. D. Mass. 1985); *In re* Guy Apple Masonry Contractor, Inc., 45 B.R. 160, 163 (Bankr. D. Ariz. 1984).

[158] *In re* Saturley, 131 B.R. 509, 516-17 (Bankr. D. Me. 1991) (citing *In re* Futuronics Corp., 655 F.2d 463 (2d Cir. 1981).

[159] Electro-Wire Prods., Inc. v. Sirote & Permutt, P.C. (*In re* Prince), 40 F.3d 356, 361 (11th Cir. 1994).

[160] 72 B.R. 418 (Bankr. D. Me. 1987).

estate. The *Eastern Inns* court found that the broker was not disinterested, vacated the approval of employment, and denied compensation.[161] The requirement of disclosure continues throughout the case.[162]

A court may sanction an attorney even if the lack of disclosure was a mistake.[163] However, courts have not agreed with the strictness of the disclosure requirements of Rule 2014(a). Some courts have taken a very strict approach and require the attorney to disclose all pertinent facts.[164] Other courts do not take such a strict approach.[165] Counsel should carefully make a full disclosure to avoid being sanctioned.

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[161] *Eastern Inns*, 72 B.R. at 421.

[162] *In re* Prudhomme, 152 B.R. 91, 105 (Bankr. W.D. La. 1993). *See In re* ESM Gov't Sec., Inc., 66 B.R. 82, 84 (S.D. Fla. 1986). *See also In re* Cropper Co., 35 B.R. 625, 631-32 (Bankr. M.D. Ga. 1983) (stating that disqualification was proper when possibility of the appearance of improper conduct existed).

[163] *See In re* Film Ventures Int'l, Inc., 75 B.R. 250, 252 (B.A.P. 9th Cir. 1987).

[164] *In re* Hathaway Ranch Ptrshp., 116 B.R. 208, 219-220 (Bankr. C.D. Cal. 1990). The *Hathaway Ranch* court noted that disqualification from the instant case and all subsequent related cases could be appropriate. *Hathaway Ranch*, 116 B.R. 220. The policy behind this strict application of the disclosure requirements is perhaps best stated as follows:

> This determination protects the bankruptcy system. . . . [P]rofessionals seeking employment with estates will have fewer problems determining which connections are to be disclosed for all connections must be disclosed. The professional cannot pick and choose which connections to disclose. No matter how old the connection, no matter how trivial it appears, the professional seeking employment must disclose it. The court and interested parties are then informed and the professional does not run the risk of serving the estate *pro bono*.

In re EWC, Inc., 138 B.R. 276, 281 (Bankr. W.D. Okla. 1992).

[165] *In re* Rusty Jones, Inc., 134 B.R. 321, 346 (Bankr. N.D. Ill. 1991). The *Rusty Jones* court aptly noted:

> This is not to say that every possible connection need be disclosed by counsel. Rule 2014 does not require an attorney to dredge up every past connection, however remote, that he or she ever had with the parties in interest in the case . . . What is important are connections that presently exist or recently existed between the attorney and the parties in interest, and also past connections of business or personal nature that are either related to the bankruptcy proceedings or could reasonably have an effect on the attorney's judgment in the case.

Rusty Jones, 134 B.R. at 346.

D. The Attorney Must be Conflict Free for Employment Under § 327(a), and Such Requirement is Continuing in Nature by Virtue of § 328(c).

If an attorney fails to avoid a disqualifying conflict of interest under 11 U.S.C. § 327(a) at anytime in the case, the Code expressly provides a penalty for such a violation.[166] 11 U.S.C. § 328(c) provides:

> Except as [otherwise] provided . . . the court may deny allowance of compensation for services and reimbursement of expenses of a professional person . . . if, at any time during such professional person's employment . . . such professional person is not a disinterested person, or represents or holds an interest adverse to the interest of the estate with respect to the matter on which such professional person is employed.[167]

The section expressly authorizes the court to deny fees for services rendered while the attorney was (1) not a disinterested person or (2) holding an interest adverse to the estate with respect to the scope of the attorney's employment.[168]

Perhaps one of the best illustrations of the interaction between Rule 2014, 11 U.S.C. § 327(a) and § 328(c) is the recent case *Electro-Wire Products, Inc. v. Sirote & Permutt, P.C. (In re Prince)*.[169] In *In re Prince*, the United States Court of Appeals for the Eleventh Circuit held that the law firm of Sirote & Permutt, P.C., (Sirote) was not entitled to compensation for its work in representing Prince (the debtor) because the firm operated under intolerable conflicts of interest which unduly prejudiced the debtor in violation of the Bankruptcy Code.[170] The Court denied Sirote all fees and expenses concerning the Debtor's bankruptcy case and disgorged the firm of all fees received.[171]

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[166] Rome v. Braunstein, 19 F.3d 54, 58 (1st Cir. 1994). Section 328(c) permits a court to deny compensation for failing to avoid a disqualifying conflict of interest. 11 U.S.C. § 328(c) (1994).

[167] 11 U.S.C. § 328(c).

[168] *Id.*

[169] 40 F.3d 356 (11th Cir. 1994).

[170] *Prince*, 40 F.3d at 360-61.

[171] *Id.* at 361. The court denied an award totaling almost $200,000. *Id.* at 359,

In *In re Prince*, Sirote filed an application for approval of employment in the Debtor's chapter 11 case under 11 U.S.C. §§ 327(a) and 1103 and an affidavit pursuant to Rule 2014(a).[172] The application and affidavit failed to reflect Sirote's prior representation of the debtor, including the following: Sirote's estate planning work that resulted in approximately $600,000 of property being conveyed by the debtor to his wife for no valuable consideration before bankruptcy; the payment of $5,056.41 for the estate work to Sirote within ninety days before the bankruptcy filing; deeds pertaining to the estate work which were not recorded until one month before the filing of the bankruptcy; the bill for recording the deeds mailed by Sirote to the debtor the day before the bankruptcy petition; work pertaining to a divorce for the Debtor; and corporate work for a corporation controlled by the Debtor.[173] Sirote also failed to disclose that he represented the debtor's wife during the debtor's chapter 11 case when Electro-Wire Products sued her on a guaranty executed in favor of Electro-Wire Products.[174] Sirote answered that complaint and had the proceedings stayed because of the debtor's bankruptcy case.[175]

Sirote filed two amendments to the application for employment that mentioned his previous representation of the debtor in matters unrelated to the bankruptcy case.[176] The amendments also revealed the work he did regarding the estate work but suggested that the work was concluded in 1988 and did not affect the bankruptcy.[177]

The court denied Sirote fees and expenses based on 11 U.S.C. § 328(c).[178] The Court concluded that although 11 U.S.C. § 328(c) is permissive in nature, Sirote did not provide

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361.

[172] *Id.* at 358.

[173] *Id.* at 358-59.

[174] *Id.* at 359.

[175] *Prince*, 40 F.3d at 359.

[176] *Id.*

[177] *Id.*

[178] *Id.* at 360. For the full text of 11 U.S.C. § 328(c), *see supra* text accompanying note 167.

the debtor "a conflict-free, impartial, independent evaluation of the potential claims of and against the estate."[179]

Specifically, the court found that Sirote was not a "disinterested person" as required by 11 U.S.C. § 327(a).[180] Because the term "creditor" includes an "entity that has a claim against the debtor that arose at the time of or before the order for relief concerning the debtor,"[181] Sirote was a creditor for the sum pertaining to the recording of the deeds and therefore was not a disinterested person under section 101(14)(A).[182]

Beyond Sirote's status as a pre-petition creditor, the representation of the debtor's wife was "undeniably an interest adverse to the debtor's estate."[183] The court notes that the phrase *"interest materially adverse to the estate"* but adopts the definition generally recognized by courts, which includes attorneys who possess "either an 'economic interest that would tend to lessen the value of the bankruptcy estate *or* that would create either an actual or potential dispute in which the estate is a rival claimant . . . *or* . . . a predisposition under the circumstances that render such a bias against the estate.'"[184] Under this definition, Sirote was not a "disinterested person" under § 101(14)(E).[185]

These conflicts of interest violated 11 U.S.C. §§ 327(a) and 328(c), and "clearly" prejudiced the debtor's estate.[186] Particularly, Sirote was unable to analyze independently the transfer

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[179] *Prince*, 40 F.3d at 360.

[180] *Id.* at 360-61. 11 U.S.C. § 101(14) provides that a *"disinterested person"* means a person who:

> (A) is not a *creditor* . . . [and]
> (E) . . . does not have an *interest materially adverse to the interest of the estate* . . . by reason of any direct or indirect relationship to, connection with, or interest in, the debtor. . ., or for any other reason. (emphasis added)

11 U.S.C. § 101(14) (1994).

[181] 11 U.S.C. § 101(10).

[182] *Prince*, 40 F.3d at 361.

[183] *Id.*

[184] *Id.* (quoting *In re* Roberts, 46 B.R. 815, 827-33 (Bankr. D. Utah 1985). (emphasis added)

[185] *Id.* at 361.

[186] *Id.*

from the debtor to his wife.[187] The court said that whether the transfer could have been challenged as a fraudulent transfer was not crucial.[188] The measure of prejudice was "not what Sirote actually did or did not do in handling [the debtor's] case, but rather whether Sirote could have unbiasedly made decisions in the best interest of its client. We think it could not."[189] The importance of a court not speculating as to the actual prejudice resulting once it is clear a conflict is present was set forth by the United States Supreme Court as follows:

> [T]he incidence of a particular conflict of interest can seldom be measured with any degree of certainty. The bankruptcy court need not speculate as to whether the result of the conflict was to delay action where speed was essential, to close the record of past transactions where publicity and investigation were needed, to compromise claims by inattention where vigilant assertion was necessary, or otherwise to dilute the undivided loyalty owed to those whom the claimant purported to represent. Where an actual conflict of interest exists, no more need be shown in this type of case to support a denial of compensation.[190]

The *Prince* court noted that whether Sirote "inadvertently or intentionally neglected to inform the court of its conflicts [was] of no import."[191] From this language, it is obvious the court reasoned that the intent of the attorney was of no consequence. Other courts agree with this proposition.[192] The arguably

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[187] *Prince*, 40 F.3d at 361.

[188] *Id.* at 360.

[189] *Id. See also* Woods v. City Nat'l Bank & Trust Co., 312 U.S. 262, 268 (1941) (concluding that attorneys should be denied compensation if they represent parties with conflicting interests). .

[190] *Id. See also* Woods v. City Nat'l Bank & Trust Co., 312 U.S. 262, 268 (1941) (concluding that attorneys should be denied compensation if they represent parties with conflicting interests).

[191] *Prince*, 40 F.3d at 361.

[192] *See* Rome v. Braunstein, 19 F.3d 54, 58 (1st Cir. 1994) ("The test is neither subjective, nor significantly influenced by the court-appointed professional's 'protestations of good faith. . .' but contemplates an objective screening for even the 'appearance of impropriety',"); *In re* Martin, 817 F.2d 175, 182 (1st Cir. 1987) (concluding that an objective test determines if actual or potential conflicts exist

harsh results of this case seem to hinge partly on the lack of candid disclosure by Sirote. In fact, the lack of candid disclosure is often cited as a ground warranting the denial of fees. Perhaps one of the reasons the lack of candid disclosure warrants sanctions is that the bankruptcy court relies on counsel's representations in the application for approval of appointment since "[i]t is not the duty of the bankruptcy judge to ferret out the falseness of . . . a statement in the debtor's application . . . ."[193] This reliance is based on the fact that "[b]ankruptcy [j]udges . . . must quickly and repeatedly make decisions 'from the bench' upon matters . . which, fairly often, present complex questions of fact and the application of intricate rules and statutes."[194]

IV. Rules of Professional Conduct

Beyond the statutory constraints, attorneys must also consider the constraints on representation imposed by the Rules of Professional Conduct. Some courts look to the Rules of Professional Conduct for guidance in ascertaining whether a conflict of interest exists in a bankruptcy proceeding[195] and

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between the attorney's interest and the estate's interest); *In re* Leslie Fay Cos., 175 B.R. 525, 536 (Bankr. S.D.N.Y. 1994) ("But when evaluating conflicts of interest, [the bankruptcy judge] must do so objectively, 'irrespective of the integrity of the person under consideration.'") (citation omitted). *See also In re* Kelton Motors, Inc., 109 B.R. 641, 649 (Bankr. D. Vt. 1989) (expressing idea that courts have inherent power to regulate attorney's conduct if conflict of interest exists); *cf. In re* Michigan Gen. Corp., 78 B.R. 479, 482 (Bankr. N.D. Tex 1987) (stating that negligence does not excuse failure to disclose).

[193] *In re* Estes, 57 B.R. 158, 161 (Bankr. N.D. Ala. 1986). *See also In re* Bob's Supermarkets, Inc., 146 B.R. 20, 22 (Bankr. D. Mont. 1992) (noting that attorney, not court, bears burden of truthfulness); *Leslie Fay Cos.*, 175 B.R. at 533 ("[I]t is the responsibility of the professional, not of the court, to make sure that all relevant connections have been brought to light.").

[194] *Estes*, 57 B.R. at 160.

[195] *See In re* Star Broadcasting, Inc., 81 B.R. 835, 839-40 (Bankr. D. N.J. 1988) (concluding that court must consult the Rules of Conduct to determine if attorney's representation of a party constitutes a conflict of interest) (numerous citations omitted); *In re* Delta Petro. (P.R.), Ltd., 193 B.R. 99, 111 (D. P.R. 1996) (considering Rule 1.16(c) of the Rules of Professional Responsibility when deciding whether a lawyer should be forced to continue representing a client and then denying compensation for services provided). *See also In re* Hessinger & Assocs.,

some courts look to the Rules of Professional Conduct in actually calculating reasonable attorney's fees due.[196] For example, Rule 1.5(a) sets forth eight factors to determine whether a fee is excessive. The Rule states as follows:

> A lawyer's fee shall be reasonable. The factors to be considered in determining the reasonableness of a fee include the following:
> (1) the time and labor required, the novelty and difficulty of the questions involved, and the skill requisite to perform the legal service properly;
> (2) the likelihood, if apparent to the client, that the acceptance of the particular employment will preclude other employment by the lawyer;
> (3) the fee customarily charged in the locality for similar legal services;
> (4) the amount involved and the results obtained;
> (5) the time limitations imposed by the client or by the circumstances;
> (6) the nature and length of the professional relationship with the client;
> (7) the experience, reputation, and ability of the lawyer or lawyers performing the services; and
> (8) whether the fee is fixed or contingent.[197]

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192 B.R. 211, 220-21 (N.D. Cal. 1996) (considering the imposition of sanctions where law firm split fees with nonattorney who failed to adequately supervise paralegals); *In re* Knights Groceries., Inc., 190 B.R. 966, 968 (Bankr. M.D. Fla. 1996) (finding that because fee charged by attorney was grossly excessive, fee arrangement was not disclosed, and attorney violated Code, Rules, and ethical rules governing fee-sharing, the attorney was required to relinquish balance of funds paid); *In re* Cupboards, Inc., 190 B.R. 969, 971 (Bankr. M.D. Fla. 1996) (finding that attorney violated both Code and Rules, as well as ethical rules, for failing to disclose fees received from debtor and appropriate sanction for conduct was total forfeiture of fees and notification to Florida Bar).

[196] *See* Liljeberg Enters., Inc. v. Emmett, Cobb, Waits & Kessenich (*In re* Liljeberg Enters., Inc.), No. CIV. A, 94-3804, 1996 WL 169128, at *3 (E.D. La. Apr. 9, 1996). In *Liljeberg*, the district court concluded that the bankruptcy judge correctly held that the applicant was entitled to reasonable attorney's fees based on the factors included in the Louisiana Rules of Professional Conduct. *Id.* at *9. since the bankruptcy judge did not consider all the factors of Rule 1.5(a), the district court remanded the case. *Id.* at *5-*6.

[197] MODEL RULES OF PROFESSIONAL CONDUCT RULE 1.5(a) (1996). These factors are also embodied in the general rule set forth in Section 46, RESTATEMENT

These factors are very similar and overlap the factors courts must consider under section 330 and under the *Johnson* factors.

Just as the factors regarding reasonable compensation overlap with the Bankruptcy Code's standards, it is generally recognized that the conflict of interest requirements under the Rules of Professional Conduct are essentially embodied in the Bankruptcy Code's conflict of interest restrictions.[198] For example, Rule 1.7 reflects the same standard set forth for the employment of "special counsel" as section 327(c).[199] This standard, that only an actual, not a potential, conflict of interest will disqualify an attorney from representing multiple clients is precisely the same as Rule 1.7. Likewise, as with the other provisions of the Code, the Rules of Professional Conduct will not likely alter the outcome of a "disqualification" inquiry by the bankruptcy court under 11 U.S.C. §§ 327(a) and 328(c).[200]

(THIRD) OF THE LAW GOVERNING LAWYERS (Proposed Final Draft No. 1, 1996) which states "[a] lawyer may not charge a fee larger than is reasonable in the circumstances or that is prohibited by law."

Likewise, the MODEL CODE OF PROFESSIONAL RESPONSIBILITY, DR 2-106(B) (1969), enumerates the following factors in determining if a fee is reasonable:

> (1) [t]he time and labor required, the novelty and difficulty of the questions involved, and the skill requisite to perform the legal service properly[;] (2) [t]he likelihood, if apparent to the client, that the acceptance of the particular employment will preclude other employment by the lawyer[;] (3) [t]he fee customarily charged in the locality for similar legal services[;] (4) [t]he amount involved and the results obtained[;] (5) [t]he time limitations imposed by the client or by the circumstances[;] (6) [t]he nature and length of the professional relationship with the client[;] (7) [t]he experience, reputation, and ability of the lawyer or lawyers performing the services[;] and (8) [w]hether the fee is fixed or contingent.

[198] *See, e.g., In re* Glenn Elec. Sales Corp., 99 B.R. 596, 601 (D. N.J. 1988).

[199] *See* Moore v. Kumer (*In re* Adam Furn. Indus., Inc.), 191 B.R. 249, 258-60 (Bankr. S.D. Ga. 1996).

[200] *See, e.g., In re* Roberts, 46 B.R. 815 837 (Bankr. D. Utah 1985). The *Roberts* court noted: "[I]t is doubtful whether this impact will be very great. This view is predicated on the fact that the Bankruptcy Code and Rules contain their own anticonflict provisions. . . . [T]he new Rules of Conduct do not greatly alter the present law on conflicts of interest . . . ." *Roberts*, 46 B.R. at 836-37.

However, if there is a difference between the standard in the Code and in the Rules of Professional Conduct, the stricter standard applies.[201]

Regardless of whether the bankruptcy court consults the Rules of Professional Conduct, the attorney should realize that beyond any discipline or denial of fees in the bankruptcy proceeding, the attorney may be subject to disciplinary or even disbarment proceedings by a state bar. In *In re Prince* the Eleventh Circuit alluded to such a result and stated that if Sirote had been a sole practitioner, as opposed to a large law firm, "disbarment proceedings would undoubtedly have ensued."[202] Besides the denial of compensation and state bar disciplinary proceedings, attorneys may be subject to discipline by the district court in which they are appearing. For instance, attorneys in the Northern District of Alabama are expressly bound by the Alabama and Model Rules of Professional Conduct and are subject to discipline for violations.[203]

V. CONCLUSION

The district court in *In re Roberts*[204] provides some guidance for an attorney in ascertaining whether to seek approval when a potential conflict of interest situation is presented. An attorney "should not petition the court for employment unless counsel conscientiously believes that there are no conflicts or *that potential conflicts are outweighed by other legally cognizable factors.*"[205] The *In re Roberts* court would require that

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[201] *Cf. In re* Amdura Corp., 121 B.R. 862, 866 (Bankr. D. Colo. 1990) (noting that commercial representation which is deemed acceptable under the rules of conduct may nonetheless not be deemed acceptable under the bankruptcy rules).

[202] *In re* Prince, 40 F.3d 356, 361 (11th Cir. 1994).

[203] N.D. ALA. L.R. LR 83.1(f). *See* D. UTAH L.R. 1(g) (subjecting attorneys practicing in United States District Court of Utah to Utah Code of Professional Responsibility); S.D. GA. L.R. 505(d) (adopting current canons of professional ethics of American Bar Association); *cf. In re* Delta Petro. (P.R.), Ltd., 193 B.R. 99, 111 n.24, 110-11 (D.P.R. 1996) (recognizing that Rules of Professional Responsibility adopted by United States District Court for District of Puerto Rico are derived from and substantially identical to the Model Rules of Professional Conduct).

[204] 75 B.R. 402 (D. Utah 1987).

[205] *Roberts*, 75 B.R. at 411. (emphasis added).

there be no actual conflicts of interest, and if there are potential conflicts, the burden is on the applicant to show there are other "legally cognizable factors"[206] to warrant approval of the employment. Other "cognizable factors" may include the "economic realities of seeking legal advice" and "the right to counsel of choice."[207] Additional considerations the bankruptcy court may weigh when deciding on the approval of the employment of professionals include "the protection of the interests of the bankruptcy estate and its creditors, and the efficient, expeditious, and economical resolution of the bankruptcy proceeding."[208] When applying for employment, the attorney must keep in mind not only the factors a court may consider but also the important role of the court in making such a decision to approve employment. As the *In re Roberts* court noted that "[t]he exercise of the court's independent and informed discretion is an important protection to clients who may not be sophisticated in assessing conflicts of interest and to the court system which has an interest in avoiding even the appearance of impropriety."[209]

Considering the important role of the court and the fact the court relies largely on the representations of counsel, the attorney must carefully and fully disclose any potential conflicts to allow the court to make an independent and informed decision. Otherwise, the court will not have a "meaningful opportunity" to determine whether to approve or disapprove the employment of an attorney.[210]

Attorneys must actively police conflicts of interest in bankruptcy cases and be vigilant in ascertaining the probability of potential conflicts progressing into actual conflicts because the

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[206] *Id.*

[207] *Id.* at 406.

[208] Harold & Williams Dev. Co. v. United States Trustee (*In re* Harold & Williams Dev. Co.), 977 F.2d 906, 910 (4th Cir. 1992). *See also In re* Philadelphia Athl. Club, Inc., 20 B.R. 328, 335 (E.D. Pa. 1982) ("A court should also consider any countervailing policies, such as permitting a litigant to retain the counsel of his choice and enabling attorneys to practice without excessive restrictions.") (quoting United States v. Miller, 624 F.2d 1198, 1203 (3d Cir. 1980)).

[209] *Roberts*, 75 B.R. at 411.

[210] *In re* Leslie Fay Cos., 175 B.R. 525, 538 (Bankr. S.D.N.Y. 1994).

costs can be high if a court finds an attorney violated the statutory provisions of the Bankruptcy Code. "[I]n deciding questions of professional ethics men of good will often differ in their conclusions."[211] Consequently, "[w]hen a practitioner is in doubt on an ethical question, the best answer is usually No."[212] The answer should be "no" despite the intent of the attorney because as Chief Judge Cardozo stated more than a half century ago, "Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior."[213]

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[211] Fund of Funds, Ltd., v. Arthur Andersen & Co., 567 F.2d 225, 227 (2d Cir. 1977).

[212] John P. Frank, *The Legal Ethics of Louis D. Brandeis*, 17 STAN. L. REV. 683, 709 (1965).

[213] Parker v. Frazier (*In re* Freedom Solar Ctr., Inc.), 776 F.2d 14, 19 (1st Cir. 1985) (quoting Meinhard v. Salmon, 164 N.E. 545, 546 (1928)).

THE IMPACT OF DILUTION IN ASSET SECURITIZATION: COMMERCIAL SEPARATION ANXIETY

Derrick Allen Dyer[*]

Business entities in need of capital are increasingly utilizing the technique of asset securitization.[1] Through asset securitization, an almost endless array of assets have found their way into the capital markets.[2] Eager to benefit from these

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[1] It has been estimated that organizations are on track to issue almost $140 billion in asset based securities in 1996. Suzanne Woolley, *What's Next, Bridge Tolls?*, BUS. WK., Sept. 2, 1996, at 64. This is an increase over 1995, where companies issued $108 billion in asset based securities, and 1994, where companies issued $75 billion in securities. *Id.*

Organizations utilizing this type of financing to raise capital include those that find traditional bank financing too expensive, those with credit ratings such that a traditional bond offering would be impossible, those attempting to expand their investor base, and organizations attempting to restructure their debt. The Committee on Bankr. and Corporate Reorganization of the Ass'n of the Bar of the City of N.Y., *Structured Financing Techniques*, 50 BUS. LAW. 527, 529-30 (1995). This type of financing has been used by organizations already in financial dire straights, *e.g.*, those already in bankruptcy. Steven L. Schwarcz, The Alchemy of Asset Securitization, 732 PRACTICING L. INST. COM. L. & PRAC. COURSE HANDBOOK SERIES 251, 272 (1995). In addition, franchisees frequently benefit from the technique. For instance, securitized financing for restaurant franchisees was predicted to account for about $500 million in financing in 1995. Jeffrey A. Tannenbaum, *More Franchisees Borrow Funds Through Loan Pools*, WALL ST. J., July 7, 1995, at B2.

[2] Traditionally, securitized assets included credit card receivables, auto loan receivables, and home equity loans. The list has now expanded to include aircraft leases, royalty streams from films, property tax liens, student loans, auto loans to people with poor credit histories, commercial real estate loans, computer lease receivables, trade receivables, telephone card receivables, medical receivables, franchisee loans, franchise fee receivables, small business loans, agricultural and

assets, investors have welcomed the variety in the market and have voraciously demanded access to these asset based securities.[3] By all indications, this demand will continue to grow.[4]

The key to this securitization frenzy, and the very essence of the transaction itself, is the ability of an organization, called an originator,[5] to legally separate itself from its right to receive future payment from its obligors.[6] Once separated, the

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farm loans, and unsecured consumer loans. Robert R. Veach, Jr., *Securitization of Assets*, 30 MAR. BULL. BUS. L. SEC. ST. B. TEX. 23, 26 (1993).

[3] This high level of demand likely is due to the fact that there have been few setbacks in the market. Because setbacks in the market have been few, asset securitization may appear to involve less risk than that which is actually involved. This perception may or may not be true. However, as the market expands to encompass riskier assets and transaction participants, this benign view of the transaction may be forced to change.

Without a doubt, asset securitization does involve risk. While certainly not plentiful, there are cases demonstrating that the financing technique is not risk free. Most notable is *In re* Towers Financial Corp. Noteholders Litigation, No. 93CIV 0810(WK)(AJP), 1995 WL 571888, at *1 (S.D.N.Y. Sept. 20, 1995), which was a class action on behalf of more than 3,500 investors who had purchased $245 million of bonds offered by Towers Financial Corporation. *Towers*, 1995 WL 571888, at *1, *5; *see also* LaSalle Nat'l Bank v. Duff & Phelps Credit Rating Co., No. 93 CIV. 4692 WK AJP, 1996 WL 754138, at *1 (S.D.N.Y. Dec. 2, 1996) (describing *Towers* transaction). Subsidiaries of Towers Financial Corporation "were to use the proceeds of the bond sales to purchase 'Qualified Health Care Receivables'." *LaSalle*, 1996 WL 754138, at *3. Instead, the funds were allegedly used to carry out a "Ponzi scheme" where "Towers used the proceeds to pay, inter alia, interest on the notes, company expenses, . . . and professional fees." *Towers*, 1995 WL 571888, at *1, *6. The complaint raised numerous allegations, several of which involved fraud on the part of various defendants. *Id.* at 4. Those sought to be held liable included various brokers, the rating agency of the securities, the indenture trustee for the bonds, the attorneys who provided legal advice to Towers, and the certified public accountants who served as auditors for the subsidiaries. *Id.*

[4] Initially, investment bankers targeted credit card receivables, auto receivables, and home equity loans. Woolley, *supra* note 1, at 64. However, as the profit on these transactions has declined, attention is now being drawn to securities in which higher fees may be charged. Included in such higher fee securities are items such as royalty streams, aircraft leases, and the like. *Id.* Also, certain municipalities now securitize tax liens and municipal leases. Mark J. Saladino, *Securitization of Municipal Obligations In The Secondary Market: The California Legislative Response*, 28 URB. LAW. 1, 1-2 (1996).

[5] Committee, *supra* note 1, at 529.

[6] Schwarcz, *supra* note 1, at 255. Commonly, although not always, assets that involve the receipt of future payments are classified as receivables. *Id.* Receivables include short term payment obligations, such as "for goods sold or ser-

income stream that flows from this payment obligation recognizes value separate and apart from the originator and is no longer burdened by declines in the originator's financial condition.[7] Furthermore, the independent income stream may become a source of financing for the originator.[8]

However, there are limits to this independence. In rare instances complete separation of the income stream from the originator may not always occur. When dilution occurs, the income stream remains burdened not only by the originator's financial condition, but also by the originator's business activities. The transaction could venture from believed panacea to financial headache. The parties involved in the transaction, therefore, must concern themselves with the risk that separation, in certain situations, may be illusory.

This article focuses on dilution and its courses related to the necessary application of the Uniform Commercial Code, federal laws, and federal regulations to the transaction. Section I provides a brief, albeit simplified, overview of asset securitization, comparing and contrasting asset securitization with other forms of receivables financing. Section II explores the separation difficulties caused by the application of Article 9 of the Uniform Commercial Code [hereinafter U.C.C.] to the transaction. Section III discusses the potential difficulties of separation encountered where the obligor of the income stream is the U.S. government. In this situation, the transaction must comply not only with the Uniform Commercial Code, but also with the Assignment of Claims Act. Section IV discusses impairment resulting from a certain class of consumers being the account obligor. Apart from the risk associated with a particular class of account obligors, the risk caused by the application of bankruptcy laws is discussed in Section V. Finally, section VI discusses the possible ramifica-

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vices rendered," and long term payment obligations such as "loans, leases, licenses, management contracts, etc." *Id.* at 274 n.7 (citation omitted).

[7] *Id.*

[8] *Id.* The organization can use the independent income stream as a vehicle into the capital markets, thus increasing the organization's alternative sources of financing. *Id.*

tions where the income stream is made the subject of a forfeiture action.

I. Overview of Asset Securitization

"Asset securitization" is an intensely complicated transaction. Likewise, defining the transaction is no simple task, with a single definition almost impossible to formulate.[9] At best, the transaction could be defined as a process through which an organization in need of financing legally separates itself from the right to receive income from an asset.[10] Often, the originator will create a separate and independent entity, which in turn will issue securities backed by the income stream on the capital markets.[11] This rather arduous task provides the originator with financing at a lower cost.[12]

However, this lengthy description lacks the totality needed to understand and appreciate the transaction.[13] The nature of the transaction is best understood in terms of that which the transaction is not. Comparing and contrasting of securitization with other types of receivables financing is therefore necessary. Since securitization is related, in certain respects, to factoring and asset based lending, an understanding of both is necessary to understand securitization.

A. Factoring

Factoring involves the sale and purchase of an account receivable.[14] The client, the organization in need of capital,

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[9] *See* Joseph C. Shenker & Anthony J. Colletta, *Asset Securitization: Evolution, Current Issues and New Frontiers*, 69 Tex. L. Rev. 1369, 1373-75 (1991) (describing the various meanings attributed to "securitization"). This difficulty is due, in part, to the common practice of using the term "securitization" to encompass many different financial transactions. *Id.* at 1374.

[10] Veach, *supra* note 2, at 24.

[11] Schwarcz, *supra* note 1, at 255. Legally separating the originator and the income stream results in a separation of "the credit quality of the assets being securitized from the credit risk of any entity." Committee, *supra* note 1, at 533.

[12] Schwarcz, *supra* note 1, at 256.

[13] Indeed, each state of the "securitization" process is relevant in defining the transaction. Shenker & Colletta, *supra* note 9, at 1375.

[14] This purchase is done by agreement. A factoring agreement typically contains the following:

sells its illiquid right to receive payment in the future for immediate cash.[15] The factor, typically a pre-existing finance company, pays the client a price discounted below the amount the particular account obligor is obligated.[16] But this price is not paid immediately. Rather, the factor pays in installments.[17]

The factor purchases the receivable without recourse, thereby assuming the risk of the account debtor's failure to repay.[18] Since the factor assumes this burden, the factor's effi-

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(1) a clear designation of the receivables covered; (2) language conveying the receivables for the designated discount price; (3) the factor's assumption of the credit risk; (4) accountings to be rendered monthly from the factor to the dealers; (5) warranties as to the genuineness of the accounts sold to the factor; (6) a right of charge-back if the debtor fails to pay due to a dispute regarding the underlying goods or services; and (7) the factor's right to maintain a reserve as protection against returns, claims, or defenses relating to the underlying transaction, unrelated claims by the account debtor, or other indebtedness owing by the dealer to the factor.

BARKLEY CLARK, THE LAW OF SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE ¶ 10.04[2] (2d ed. 1988).

[15] Schwarcz, *supra* note 1, at 264.

[16] *Id.* Health care receivables, for example, are typically discounted five to ten percent. *Id.* at 265. In addition to this discount, a factor will charge "a factoring fee that may be as high as fifteen to twenty percent of the receivable." *Id.* (citation omitted).

[17] *Id.* at 265.

[18] *Id.* at 264. In determining if the transaction is a sale, the nature of the recourse is most critical. CLARK, *supra* note 14, at ¶ 4.04[2] n.218. If the purchase of the receivable provides too much recourse, the purchase may be deemed a security interest rather than a purchase. *See In re* Navigation Tech. Corp., 880 F.2d 1491, 1493 (1st Cir. 1989) (finding assignment of royalties was for security purposes only so payments may be made to bankruptcy trustee); *In re* Evergreen Valley Resort, Inc., 23 B.R. 659, 661 (Bankr. D. Me. 1982) (listing indicators used to determine if security interest was created). In determining if the transaction is an outright sale or a disguised security interest, courts will look to the form of the transaction, rather than the labels placed on it by the parties. *See* Major's Furniture Mart, Inc. v. Castle Credit Corp., 602 F.2d 538, 543 (3d Cir. 1979) (explaining that courts will disregard labels placed on transaction when attempting to define transaction).

The end result of the transaction being construed as a "security interest" rather than a sale is that, in the event of the debtor's bankruptcy, the account becomes part of the debtor's bankruptcy estate. Schwarcz, *supra* note 1, at 255. Hence, the factor's right to receive payment from the account debtors could be

ciency at collection is the key to reducing the risk associated with the customer's failure to pay.[19] After the sale, The account debtor, or customer, is immediately instructed to make all payments directly to the factor instead of the client.[20] The factoring transaction requires the creation of no other structure and it exists only between the customer and the factor. Once notification occurs, the factor then becomes responsible for collecting the debt.[21]

B. Asset Based Lending[22]

Asset based lending, like factoring, is dependent upon an income stream.[23] However, unlike factoring which considers particular receivables, asset based lending involves the pooling

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impaired.

[19] Gregory R. Salathé, *Reducing Health Care Costs Through Hospital Accounts Receivable Securitization*, 80 VA. L. REV. 549, 562 (1994).

[20] *Id.* at 264. Until notified, the account debtor may continue to pay the client. *See, e.g.*, Warrington v. Dawson, 798 F.2d 1533, 1536-39 (5th Cir. 1986) (holding account debtor not required to pay twice where requirements of § 9-318 not met); Estate of Haas v. Metro Goldwyn-Mayer, Inc., 617 F.2d 1136, 1140 (5th Cir. 1980) (finding assignment invalid where notice to account debtor insufficient); Northwest Nat'l Bank v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 757 S.W.2d 182, 186 (Ark. Ct. App. 1988) (affirming assignment ineffective where notice ineffective); Kirby v. Palos Verdes Escrow Co., 227 Cal. Rptr. 785, 788 (Cal. Ct. App. 1986) ("The debtor is thus protected by the [U.C.C.] if he pays the assignor before receiving notice of the assignment."); First Trust & Sav. Bank v. Skokie Fed. Sav. & Loan Ass'n, 466 N.E.2d 1048, 1049-50 (Ill. 1984) (interpreting U.C.C. as allowing debtor to make payments to assignor until debtor receives notice). Section 9-318(3) of the U.C.C. provides:

> The account debtor is authorized to pay the assignor until the account debtor receives notification that the amount due or to become due has been assigned and that payment is to be made to the assignee. A notification which does not reasonably identify the rights assigned is ineffective. If requested by the account debtor, the assignee must seasonably furnish reasonable proof that the assignment has been made and unless he does so the account debtor may pay the assignor.

U.C.C. § 9-318(3) (1996). Thus, notification is critical to the factoring transaction.

[21] Schwarcz, *supra* note 1, at 264.

[22] This type of financing has also been called "commercial finance," "monitored lending," and "leveraged finance." Joseph H. Levie, *Asset Based Lending*, R171 A.L.I.-A.B.A. RESOURCE MATERIALS BANKING & COM. LENDING LAW 369, 373 (1990).

[23] *Id.* at 373.

of eligible receivables.[24] This pool of receivables forms the basis for a line of credit. The lender advances money up to a certain percentage of these eligible receivables.[25] To protect its interest, the lender takes a security interest. But the lender's security interest extends not only the borrower's eligible receivables forming the basis of the line of credit, but also in those accounts deemed ineligible.[26]

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[24] *Id.* at 276. Eligible receivables are typically accounts receivables only. *Id.* at 376. However, not all accounts are suitable for the transaction. *Id.* Accounts receivables which are not "eligible receivables" include:

> (1) Consignment sales or sales made on a sale-and-return basis . . . ;
> (2) "Rack sales" where the custom of the industry permits an automatic return . . . ;
> (3) Progress billings, in which the entire account receivable is uncertain of collection until the transaction is completed;
> (4) Sales to affiliates of the borrower;
> (5) "Concentrations" where too large a portion of the borrower's sales are made to a single person or group of persons. A no-offset letter or standby letter of credit may be employed to cure this deficiency;
> (6) Transactions where the customer's solvency is in question;
> (7) "Contras", i.e., those accounts where the borrower's sales are made to a single person or group of persons. A no-offset letter or standby letter of credit may be employed to cure this deficiency;
> (8) Sales which are coupled with maintenance obligations;
> (9) Certain kinds of receivables which are subject to encumbrances or to first liens in favor of third parties . . . .

Id. at 376-77.

[25] *Id.* at 373. The parties agree upon the amount at the outset of the transaction. *Id.*

[26] *Id.* Therefore, the lender must have the borrower execute a security agreement, and the lender must also perfect its security interest. *See* U.C.C. § 9-303(1) (describing perfection of security interest). A properly perfected security interest primes those interest which perfect at a later date. The first filed security interest, therefore, is superior to most other interest. U.C.C. § 9-312(5). Without perfection, the creditor's interest may be primed. Section 9-301(1) of the U.C.C. provides:

> Except as otherwise provided in subsection (2), an unperfected security interest is subordinate to the rights of
> (a) persons entitled to priority under Section 9-312;
> (b) a person who becomes a lien creditor before the security interest is perfected;
> (c) in the case of goods, instruments, documents, and chattel paper, a person who is not a secured party and who is a transferee

The principal distinction between asset based lending and either factoring or asset securitization is that asset based lending involves a loan.

Since it is a loan, the borrowing party's balance sheet reflects a liability.[27] Aside from these distinctions, this type of financing does share subtle similarities with securitization similarities which shall be discussed below. A further distinction is that while factoring occurs on a notification basis, notification is not an element of asset based lending. In asset based lending, the account debtors continue to make payments

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> in bulk or other buyer not in the ordinary course of business or is a buyer of farm products in ordinary course of business, to the extent that he gives value and receives delivery of the collateral without knowledge of the security interest and before it is perfected;
>
> (d) in the case of accounts, general intangibles and investment property, a person who is not a secured party and who is a transferee to the extent that he gives value without knowledge of the security interest and before it is perfected.

U.C.C. § 9-301(1). But no security interest can be perfected until it has first attached. U.C.C. § 9-303(1). Attachment occurs when:

> (a) the collateral is in the possession of the secured party, or the debtor has signed a security agreement which contains a description of the collateral and in addition, when the security interest covers crops growing or to be grown or timber to be cut, a description of the land concerned;
>
> (b) value has been given; and
>
> (c) the debtor has rights in the collateral.

U.C.C. § 9-203(1). Thus, without a security agreement in the accounts, perfection could not occur. The document need not be styled as a security agreement. Nor in certain situations is it required that the debtor specifically grant the lender a security interest. *See, e.g.,* Sommers v. IBM, 640 F.2d 686, 689 (5th Cir. 1981) (explaining security agreement need not expressly contain words granting security interest); *In re* Bollinger Corp., 614 F.2d 924, 928 (3d Cir. 1980) (looking to entire transaction to determine if security interest exists); *In re* Numeric Corp., 485 F.2d 1328, 1331 (1st Cir. 1973) ("no need to insist upon a separate document entitled 'security agreement' as a prerequisite for enforcement . . . .").

However, certain jurisdictions do, in fact, require specific words of grant. *See, e.g., In re* Don Miller, Inc., 35 B.R. 714, 716-17 (Bankr. E.D. Wis. 1984) (refusing to construe "is secured by" as granting security interest); Barth Bros. v. Billings, 227 N.W.2d 673, 678 (Wis. 1975) (finding security interest not perfected where debtor failed to sign security agreement). Thus, in order for the borrower to protect its interest, the parties should always sign a security agreement.

[27] Conversely, since securitization is a sale, the originator's balance sheet does not indicate a liability from the transaction. Schwarcz, *supra* note 1, at 262.

to the borrower.[28] However, the parties may alter the place where the account debtors make payments. In doing this, lenders frequently employ a lockbox arrangement wherein the account debtors route their payments to a post office box which is under the complete control of the lender.[29] The lender then deposits the funds into a bank account held by the borrower.[30]

C. Asset Securitization

Asset securitization contains elements of both factoring and asset based lending. It involves the pooling of "eligible" income streams and the subsequent sale of these assets.[31] Parties benefit from the transaction because, in certain situations, the cost of financing is reduced.[32]

Any asset securitization begins with the originator, the party in need of financing.[33] The originator initiates the process by identifying suitable assets, or income streams, available for securitization.[34] This process is critical, because the selection of the proper assets reduces the potential risk of loss to the eventual party providing financing.[35] Therefore, identification enhances the value of the asset pool.

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[28] Levie, *supra* note 22, at 386.

[29] *Id.* at 386. In asset based lending, collections are routed through the lender via this lockbox arrangement. *Id.* Where the lender is a bank, usually the lock box will be located at the bank itself. *Id.* at 374.

[30] *Id.* at 374. As payments are received, the lender applies the payments against the borrower's loan. *Id.* This process reduces the amount owed the lender, allowing the borrower to receive further advances. *Id.* Securitized transactions may employ a similar lockbox arrangement.

[31] "[A]ny asset that provides a predictable stream of cash flow or that can be converted into a predictable amount of cash can be securitized." Committee, *supra* note 1, at 532. Assets best suited for securitization involve those with standardized terms and delinquency and loss experience which is capable of supporting an actuarial analysis. Shenker & Colletta, *supra* note 9, at 1377.

[32] Schwarcz, *supra* note 1, at 255.

[33] *Id.*

[34] *Id.*

[35] This process also distinguishes the transaction from factoring. Where factoring is used, the factor reduces his risk of loss through its superior collection techniques. *See supra* notes 14-21 and accompanying text.

Once identified, the "suitable" income streams are pooled.[36] The most significant aspect of the transaction then takes place. The pooled income streams are legally separated from the originator through the use of a Special Purpose Vehicle [hereinafter SPV].[37] The SPV then purchases the income stream from the originator.[38] However, the SPV does not use its own money to fund the purchase. Rather, its purchase is funded either through the issuance of either debt or equity in the capital markets.[39] The SPV uses the purchased income received streams to service the debt to the investors.[40]

With the SPV's purchase, legal separation from the originator should occur.[41] However, the transaction cannot end

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[36] Schwarcz, *supra* note 1, at 255.

[37] *Id.* The SPV may or may not be an entity created by the originator. However, the SPV should be structured according to the type of asset to be securitized. Committee, *supra* note 1, at 568-76. Thus, where the assets are a single pool of discrete assets, the SPV creator uses a liquidating trust or corporation. If the assets will be sold from time to time, the SPV creator should structure a facility using a revolving purchase obligation or master trust. If short term accounts receivables are involved, SPV creator should use a SPV with reinvestment periods. *Id.* at 576-81.

Previously, the often overwhelming costs associated with the transaction prevented smaller organizations from taking advantage of the benefits of structured financing. Schwarcz, *supra* note 1, at 264-65. This "cost" is typically associated with the creation of the SPV. *Id.*

Instead of creating a separate SPV, an entity may now employ the services of a pre-existing entity. *Id.* at 260. A commercial or investment bank usually administers the pre-existing entity, which services multiple originators. *Id.* Servicing multiple originators reduces the cost to the originators because each participating originator takes advantage of the resulting economy of scale. *Id.*

[38] *Id.* at 255.

[39] *Id.*

[40] Steven L. Schwarcz, *Structured Finance: The New Way to Securitize Assets*, 11 CARDOZO L. REV. 607, 609 (1990).

[41] Schwarcz, *supra* note 1, at 255. In securitization, the purchase of the income stream differs from other financing techniques. As previously indicated, factoring occurs on a notification basis. *See supra* note 19. However, securitization entails no such notification.

Furthermore, notification may adversely affect the SPV's ability to collect from the account debtors. *See* Meredith Jackson, *Leap of Faith: Asset-Based Lending To Asset-Backed Securitization-A Case Study*, 2 STAN. J.L. BUS. & FIN. 193, 203-04 (1995) ("Rising Star was justifiably concerned that notices to its customers, instructing them to pay a third party, would adversely affect its collections."). Ideally, the income stream is separated from the originator, and the principal risk involved in the transaction is the risk of nonpayment. Schwarcz, *supra* note 1, at

with this legal separation. In addition, the assets must also be insulated from any financial hardships of the SPV.[42]

To provide the requisite assurances to investors, the SPV must be structured properly.[43] The SPV must be bankruptcy-remote, which may be accomplished by restrictions made in the corporate governance procedures.[44] Where the governance procedures are drafted properly, in order to voluntarily seek bankruptcy protection, the SPV, if a corporation, should require a super majority vote. Likewise, the ability of creditors to place the SPV into bankruptcy should also be limited.[45] This may be accomplished by requiring voluntary creditors of

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256. Therefore, notification may increase the risk associated with the transaction and ultimately increase the cost related to the transaction. This would be reflected in the cost of the credit enhancement necessary to carry out the transaction. In the end, the cost of the credit enhancement may undermine the benefits offered by securitization.

To prevent this result, a lockbox arrangement is often used that is similar to the lockbox technique of asset based lending. *See supra* note 31, and accompanying text. In certain situations, the originator, after the sale of the receivables, would continue to act as "servicer" by "monitor[ing] and collect[ing] the assets and administer[ing] the cash flow of the asset pool." Committee, *supra* note 1, at 548.

[42] Kirk Cypel, Comment, *Federal Assignment-Backed Securities (Fast-Backs): Financing Accounts Receivable Through Securitization*, 27 Loy. L.A. L. Rev. 1195, 1200-01 (1994). Where the assets could be impacted by the financial hardships of the SPV, investors may not ultimately feel comfortable with the risk associated with the assets. *Id.* Therefore, demand would remain low notwithstanding the separation of the assets from the originator. *Id.* With low demand, the value of the assets would not be maximized, and the purpose of the transaction would be undermined. *Id.*

[43] Schwarcz, *supra* note 1, at 255.

[44] As a matter of public policy, an agreement prohibiting a debtor from filing bankruptcy has been held to be void. *See In re* Markizer, 66 B.R. 1014, 1018 (Bankr. S.D. Fla. 1986) (agreeing to waiver of bankruptcy discharge is against public policy); *In re* Tru Block Concrete Prods., Inc., 27 B.R. 486, 492 (Bankr. S.D. Cal. 1983) ("It is a well settled principal that an advance agreement to waive the benefits conferred by the bankruptcy laws is wholly void as against public policy."); *In re* George, 15 B.R. 247, 248-49 (Bankr. N.D. Ohio 1981) (refusing to enforce pre-bankruptcy waiver because conflicted with basis of Bankruptcy Code); *In re* Adana Mortgage Bankers, Inc., 12 B.R. 989, 1009 (Bankr. N.D. Ga. 1980) (recognizing that any waiver of rights under Bankruptcy Act is void); *In re* Kriger, 2 B.R. 19, 23 (Bankr. D. Or. 1979) (explaining waiver disallowed and against public policy). Based on this case law, a blanket prohibition on filing bankruptcy is unenforceable.

[45] Schwarcz, *supra* note 1, at 255.

the SPV to execute an agreement not to file an involuntary petition against the SPV until 366 days after the securities issued by the SPV have been paid.[46] Further protection may be afforded by limiting the ability of the SPV to engage in certain activities, allowing only those activities necessary or incidental to financing. Lastly, the SPV may also grant the investors a security interest in the income stream.[47]

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[46] Committee, *supra* note 1, at 558. The agreement must not be filed until 366 days after the securities have been paid in order to avoid the SPV's payment to the investors to be recaptured pursuant to 11 U.S.C. § 547. Committee, *supra* note 1, at 558. Specifically, 11 U.S.C. § 547(b) provides:

> Except as provided in subsection (c) of this section, the trustee may avoid any transfer of an interest of the debtor in property—
> (1) to or for the benefit of a creditor;
> (2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
> (3) made while the debtor was insolvent;
> (4) made—
> (A) on or within 90 days before the date of the filing of the petition; or
> (B) between 90 days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and
> (5) that enables such creditor to receive more than such creditor would receive if—
> (A) the case were a case under chapter 7 of this title;
> (B) the transfer had not been made; and
> (C) such creditor received payment of such debt to the extent provided by the provisions of this title.

11 U.S.C. § 547(b).

Section 550 of the Bankruptcy Code would make the investors liable to the SPV's bankruptcy estate. 11 U.S.C. § 550(a). That section provides:

> Except as otherwise provided in this section, to the extent that a transfer is avoided under section 544, 545, 547, 548, 549, 553(b) or 724(a) of this title, the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from
> (1) the initial transferee of such transfer or the entity for whose benefit such transfer was made; or
> (2) any immediate or mediate transferee of such initial transferee.

11 U.S.C. § 550(a).

[47] If the SPV grants the investors a security interest in the accounts, the "two tier" problem may arise. CLARK, *supra* note 14, at ¶ 1.03[3]. Although, initially, the investors must be concerned with the proper perfection of the SPV's interest, they must also be concerned with the proper perfection of their interests. *Id.* In taking the security interest, the location of perfection is important. In this instance, perfection would occur where the SPV is located. *See* U.C.C. § 9-103(3)(b)

Assurance of repayment is also provided to investors in the form of credit enhancements.[48] Credit enhancements protect the investors from the risk that the SPV will be unable to repay its debt.[49] Thus, the type or types of credit enhancements form an integral part of the transaction.[50]

Credit enhancements may be either external or internal.[51] External credit enhancements rely on the credit of third parties and include letters of credit issued by banks,[52] surety bonds issued by insurance companies, guarantees issued by financial assurance companies, and subordinated loans made by third parties.[53] Internal credit enhancements, however, are dependent on the value of the securitized asset or provisions by the originator.[54] This would include, among other things, the originator's capital contribution to the originator or the use of "subordinated debt."[55]

("The law . . . of the jurisdiction in which the debtor is located governs the perfection and the effect of perfection or non perfection of the security interest.").

[48] Schwarcz, *supra* note 1, at 260-61. A credit enhancement differs from a liquidity facility in that a liquidity facility does not insure against a failure to pay. Committee, *supra* note 1, at 550-51. Rather, a liquidity facility insures that the investors will be paid timely. *Id.* Without such a facility, because the cash flows from the securitized assets are not paid exactly on the dates required, the SPV would be unable to repay the investors. *Id.*

[49] Schwarcz, *supra* note 1, at 260.

[50] *Id.* at 261. In evaluating securities, rating agencies consider the credit enhancements. *Id.* These agencies also consider "the strength of the originator, the bankruptcy remoteness of the structure, and the experience and capability of the conduit's administrator and servicer." *Id.* at 274 n.29.

[51] *Id.* at 259-60.

[52] Letters of credit are covered by Article 5 of the U.C.C. *See* U.C.C. § 5-103. Thus, participants in asset securitization also need to be ware of the effect of Article 5.

[53] Schwarcz, *supra* note 1, at 259-60.

[54] *Id.* at 263.

[55] *Id.* This level of enhancement involves the purchase by sophisticated investors of subordinated securities. *Id.* Due to the higher levels of risk inherent in this transaction, "the interest rate on these subordinated securities would be higher than the interest rate" on other securities issued by the SPV which also offer less risk. *Id.* Notably, the use of this structure can result in an increase in the entities able to provide a credit enhancement. *Id.* Furthermore, although the capital reserve requirements typically increase the expense of credit enhancement, investors in subordinated securities have no rating requirement. *See* Schwarcz, *supra* note 1, at 263. Therefore, in some instances, the cost associated with credit

The financially stable SPV is then in a position to entice investors into investing. The SPV then issues debt or securities in the capital markets to fund its purchase. Therefore, using the SPV, the originator is allowed access to the lower interest rates found in the capital markets.[56] As the SPV pays the investors a lower rate of interest, this savings is passed on to the originator through the SPV's higher purchase price for the receivable. However, this is not the sole benefit of securitization. Unlike other types of financing, the originator's debt-to-equity ratio does not increase.[57] With securitization, the transaction is structured as a sale.[58] This differs from asset based lending where the capital infusion also results in liability to the party obtaining the loan with asset based lending, the borrower's leverage increases, and therefore the borrower's ability to obtain funds in the future decreases.[59] But this does not occur with securitization, because the transaction is recorded as a sale and is not reflected as a liability.[60] Thus, the originator's debt-equity ratio does not increase, and more importantly, the originator is not foreclosed from incurring debt in the future.

As seen, simple description of securitization is not possible. Like factoring, securitization involves the sale of an income stream. However, unlike factoring, the sale does not involve deep discounts. Therefore, the originator receives access to greater amounts of capital than in factoring. Additionally, unlike either asset based lending or factoring, securitization requires the use of an SPV. Indeed, securitization is more complicated than its financial cousins. However, it is its very complexity which allows the transactions participants.

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enhancement may be less expensive. *Id.*

[56] *Id.* at 254. Securitization is only beneficial "when the cost of funds, reflected in the interest rate that is necessary to entice investors to purchase the SPV's securities, is less than the cost of the originator's other, direct sources of funding." *Id.* at 256.

[57] *Id.* at 262-63.

[58] Schwarcz, *supra* note 1, at 262.

[59] *Id.*

[60] *Id.* at 262-63.

II. THE APPLICATION OF THE UNIFORM COMMERCIAL CODE

Securitization is premised upon the ability of the originator legally to separate itself from an income stream. However complete separation is not always possible.[61] This failure is due, in large part, to the application of the Uniform Commercial Code. The impact of the U.C.C. on the separation of the asset is seen at the very crux of the transaction: the purchase of the asset.[62]

Although the sale of an asset to be securitized is beyond the scope of Article 2,[63] it is not necessarily beyond the scope

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[61] *See* Cypel, *supra* note 42, at 1204.

[62] Without this purchase, the asset cannot be separated from the originator, and asset securitization is unattainable. Moreover, in certain instances, contracts prohibit the assignment of an account. However, such a prohibitory term in a contract may be unenforceable pursuant to § 9-318(4) of the U.C.C., which states:

> A term in any contract between an account debtor and an assignor is ineffective if it prohibits assignment of an account or prohibits creation of a security interest in a general intangible for money due or to become due or requires the account debtor's consent to such assignment or security interest.

U.C.C. § 9-318(4). Thus, the provisions of Article 9 may make the sale possible. *See* Mississippi Bank v. Nickles & Wells Const. Co., 421 So. 2d 1056, 1059 (Miss. 1982) (stating that Mississippi interprets and enforces U.C.C. § 9-318(4) so as to disallow contract provisions which prohibit assignments of accounts); Aetna Cas. & Sur. Co. v. Bedford-Stuyvesant Restoration Constr. Corp., 455 N.Y.S.2d 265, 266 (N.Y. App. Div. 1982) (holding provision prohibiting assignment without written consent ineffective).

[63] The scope of Article 2 extends only to "transactions in goods." U.C.C. § 2-102. Specifically, section 2-102 of the U.C.C. provides:

> Unless the context otherwise requires, this Article applies to transactions in goods; it does not apply to any transaction which although in the form of an unconditional contract to sell or present sale is intended to operate only as a security transaction nor does this Article impair or repeal any statute regulating sales to consumers, farmers or other specified classes of buyers.

U.C.C. § 2-102. An account receivable or any right to receive future payment is not a "good." *See* U.C.C. § 2-105(1) (defining "goods" as "all things (including specially manufactured goods) which are movable at the time of identification to the contract for sale other than the money in which the price is to be paid, investment securities (Article 8) and things in action"). Since contract rights are typically not thought of as "movable," which is a requisite characteristic of "goods," the right to receive payment in the future, as in the case of receivables, is excluded from Article 2.

of Article 9.[64] Specifically, § 9-102(1)(b) of the U.C.C. applies, with some exceptions, "to any sale of accounts or chattel paper."[65] An account is "any right to payment for goods sold or leased or for services rendered which is not evidenced by an instrument or chattel paper, whether or not it has been earned by performance."[66] Thus, if the originator sells an "account," as defined by § 9-106 of the U.C.C., the sale is governed by the provisions of Article 9.

The most critical ramification of the sale of an account being within the scope of Article 9 is that the purchase must be perfected like a security interest.[67] Without perfection, both the SPV's interest and the investor's interest in the assets may be severely impaired under Article 9's system of priority. The ultimate result of this impairment would be that the income streams are not isolated from the originator, threatening the very underpinnings of the transaction.

Like any other recording system, Article 9 has a system of determining which interests are superior to others, or which interest have priority over others. Priority, under the U.C.C., is determined primarily by the first to file rule of § 9-312(5).[68]

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[64] All states have enacted Article 9. However, this is not to say that Article 9 is the same in each state of the Union. Instead of adopting Article 9, each state may have adopted modified versions of the Article. Thus, perfect uniformity has not yet been achieved for commercial transactions in the United States. Notably, Article 9 is now subject to revision, with a revised version due by 1998.

[65] U.C.C. § 9-102(1)(b). *See* District of Columbia v. Thomas Funding Corp., 593 A.2d 1030, 1033 (D.C. 1991) (concluding that Article 9 governs sales of accounts and security interests in accounts); Gold Coast Leasing Co. v. California Carrots, Inc., 155 Cal. Rptr. 511, 514 (Cal. Ct. App. 1979) (reasoning that scope of U.C.C., as adopted by the state of California, includes assignment of accounts). In addition, pursuant to § 9-105(1)(m) of the U.C.C. a secured party under Article 9 also includes "a person to whom accounts or chattel paper have been sold." U.C.C. § 9-105(1)(m).

While Article 9 encompasses the outright sale of accounts, the outright sale of "general intangibles" is presently excluded. U.C.C. § 9-102. This odd result will likely change with the revision of § 9-102(1)(b), which will result in the outright sale of general intangibles, like the outright sale of accounts, being governed by the provisions of Article 9.

[66] U.C.C. § 9-106.

[67] *See* U.C.C. § 9-302 (explaining when filing is required to perfect security interest). The rules governing perfection are found at sections 9-103 (Perfection of Security Interests in Multiple State Transactions), 9-401 (Place of Filing), 9-402 (Formal Requisites of Financing Statement), and 9-403 (Duration of Filing).

[68] U.C.C. § 9-312(5). Section 9-312(5) of the U.C.C. provides:

Under this section, the party who perfects its security interest has an interest superior to all other parties who perfect at a later date.[69] This rule applies regardless of which party was the first to actually acquire an interest in the asset.[70] When the first to file rule is applied to the SPV, the result is that the SPV's interest in the income stream may be primed.[71] To

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> In all cases not governed by other rules stated in this section . . . priority between conflicting security interests in the same collateral shall be determined according to the following rules:
>
> (a)Conflicting security interests rank according to priority in time of filing or perfection. Priority dates from the time filing is first made covering the collateral or the time the security interest is first perfected, whichever is earlier, provided that there is no period thereafter when there is neither filing nor perfection.
>
> (b)So long as conflicting security interest are unperfected, the first to attach has priority.

U.C.C. § 9-312(5).

[69] *See In re* Contractor's Glass Co., 152 B.R. 270, 273 (Bankr. W.D. Ark. 1992) (holding filed security interest was superior to subsequently perfected security interest); Parker Roofing Co. v. Pacific First Fed. Sav. Bank, 796 P.2d 732, 736-37 (Wash. Ct. App. 1990) (holding first party to file security agreement and financing statement had priority rights as to judgment debtor). In addition, a party who properly files a security interest has an interest superior to those who fail to perfect at all. *Cf.* Small v. Beverly Bank, 936 F.2d 945, 948-49 (7th Cir. 1991) (concluding that bank who received a lien perfected by order of the Bankruptcy Court had superior rights to unperfected party).

[70] *See* S. Lotman & Son, Inc. v. Southeastern Fin. Corp., 263 So. 2d 499, 500 (Ala. 1972) (affirming lower court's decision that party who files security interest has priority over parties who later file, regardless of which party was first to create the security interest).

[71] However, this result is not mandated. In certain instances, the SPV who is tardy in filing may, in fact, prevail over a party who filed prior to the SPV. For example, if the account debtors, or obligors, issue checks to the SPV which are properly indorsed or made payable to the SPV, the SPV may prime the later filed interest. U.C.C. § 9-309. Section 9-309 of the U.C.C. provides:

> Nothing in this Article limits the rights of a holder in due course of a negotiable instrument (Section 3-302) or a holder to whom a negotiable document of title has been duly negotiated (Section 7-501) or a bona fide purchaser of a security (Section 8-302) and such holders or purchasers take priority over an earlier security interest even though perfected. Filing under this Article does not constitute notice of the security interest to such holders or purchasers.

U.C.C. § 9-309. Thus, where the SPV may qualify as a holder in due course, it may prime the interest of the later filed entity. *See* Allstate Fin. Corp. v.

prevent such a result, the SPV must perfect its purchase of the asset as soon as possible.

Failure to perfect or failure to do so promptly may result in the asset not completely separating from the originator.[72] This risk is most evident in the event of the originator's bankruptcy. Pursuant to 11 U.S.C. § 544(a), the bankruptcy trustee is given the following powers:

> The trustee shall have, as of the commencement of the case, and without regard to any knowledge of the trustee or of any creditor, the rights and powers of, or may avoid any transfer of property of the debtor or any obligation incurred by the debtor that is voidable by
>
> (1) a creditor that extends credit to the debtor at the time of the commencement of the case, and that obtains, at such time and with respect to such credit, a judicial lien on all property on which the creditor on a simple contract could have obtained such a judicial lien, whether or not such a creditor exists;
>
> (2) a creditor that extends credit to the debtor at the time of the commencement of the case, and obtains, at

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Financorp, Inc., 934 F.2d 55, 61 (4th Cir. 1991) (explaining that plain language of § 9-309 gives holder in due course priority); Thorp Commercial Corp. v. Northgate Indus., Inc., 490 F. Supp. 197, 204 (D. Minn. 1980) ("A holder in due course takes priority over an earlier perfected security interest . . . ."), *rev'd on other grounds* 654 F.2d 1245 (8th Cir. 1981); Dallas Bank & Trust Co. v. Frigiking, Inc., 692 S.W.2d 163, 166 (Tex. Ct. App. 1985) (finding Bank was holder in due course with priority over prior security interests).

[72] Because the transaction is governed by Article 9, a SPV that is not created by the originator must file a termination statement in addition to filing the financing statement. U.C.C. § 9-404. The need to file a termination statement is triggered

> whenever there is no outstanding secured obligation and no commitment to make advances, incur obligations or otherwise give value, the secured party must on written demand by the debtor send the debtor, for each filing officer with whom the financing statement was filed, a termination statement to the effect that he no longer claims a security interest under the financing statement. . . .

U.C.C. § 9-404. Failure to do so, may expose the SPV to damages. *See* Kultura, Inc. v. Southern Leasing Corp., 923 S.W.2d 536, 539-40 (Tenn. 1996) (concluding that secured creditor may be liable for statutory damages and penalties, resultant consequential damages, and tortious intentional interference with prospective economic advantage if outside Tennessee).

> such time and with respect to such credit, an execution against the debtor that is returned unsatisfied at such time, whether or not such a creditor exists . . . .[73]

This section cloaks the trustee with the authority of one of the originator's judgment creditors. Hence, the bankruptcy trustee has strong arm powers.[74] A judgment creditor who enrolls judgment prior to the SPV's perfection of its interest in the income stream would have superior interest in the stream over the SPV. As a result, the SPV's interest would be primed. The end result is that, without perfection, the trustee avoids the sale of the income stream while retaining the future income streams of the benefit of the estate.[75] Therefore, the SPV and

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[73] 11 U.S.C. § 544(a).

[74] Unlike Chapter 7 bankruptcy, Chapter 11 bankruptcy rarely entails appointing a bankruptcy trustee. Rather, when the bankruptcy case is filed, the debtor becomes the debtor in possession. 11 U.S.C. § 1101. The debtor in possession, like a trustee, serves as a fiduciary for the creditors of the bankruptcy estate. *See In re* James River Assocs., 156 B.R. 494, 498 (Bankr. E.D. Va. 1993) (concluding that debtor in possession had fiduciary duty to collect rent); *In re* Rivers, 167 B.R. 288, 300 (Bankr. N.D. Ga. 1994) (holding that debtor in possession is fiduciary because is empowered to perform duties of trustee); *In re* Waldvogel, 125 B.R. 13, 15 (Bankr. E.D. Wis. 1991) (holding that debtor in possession is fiduciary for benefit of creditors); *see also In re* Phillips, 966 F.2d 926, 929 (5th Cir. 1992) (reasoning that general partner who becomes debtor in possession has conflicting responsibilities to creditors and co-partners). Moreover, a Trustee and debtor in possession have equal authority. Specifically, 11 U.S.C. § 1107(a) provides:

> Subject to any limitations on a trustee serving in a case under this chapter, and to such limitations or conditions as the court prescribes, a debtor in possession shall have all the rights, other than the right to compensation under section 330 of this title, and powers, and shall perform all the functions and duties, except the duties specified in sections 1106(a)(2), (3), and (4) of this title, of a trustee serving in a case under this chapter.

11 U.S.C. § 1107(a). Thus, although the provisions of 11 U.S.C. § 541 apply to trustees, it also applies to debtors in possession. *See In re* Century Brass Prods., Inc., 22 F.3d 37, 39-40 (2d Cir. 1994) (claiming debtor in possession is subject to same restrictions as trustee, including statute of limitations); *In re* Williams, 190 B.R. 728, 736 (D.R.I. 1996) (stating debtor in possession has rights and duties of bankruptcy trustee); *In re* Regensteiner Printing Co., 122 B.R. 323, 326 (N.D. Ill. 1990) (declaring debtor in possession has powers and duties of bankruptcy trustee).

[75] Section 551 of the Bankruptcy Code provides:

> Any transfer avoided under section 522, 544, 545, 547, 548, 549 or

the investors would lose their superior interest.[76] Moreover, if the originator is in Chapter 11 bankruptcy, the "trustee" would likely be the originator.[77] Thus, the very party who created the transaction could void it.[78]

To prevent this result, the SPV may contend that it is exempted from complying with the filing requirement by operation § 9-302(1)(e) of the U.C.C..[79] Under that provision, a financing statement need not be filed if the assignment, or sale for our purposes, does not alone or as an amalgamation of assignment to the same SPV, represent a significant part of the total amount of the originator's accounts.[80] However, this argument involves a certain level of uncertainty, because there is not one certain test used to determine when the exception is

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724(a) of this title, or any lien void under section 506(d) of this title, is preserved for the benefit of the estate but only with respect to property of the estate.

11 U.S.C. § 551.

[76] In such a situation, the investors would recover from the credit enhancements provided.

[77] This result is caused by the characterization of the former debtor as a debtor in possession. Theoretically, the debtor in possession and the party creating the interest are two separate entities. Upon filing for bankruptcy protection, the party creating the interest is divested of all legal and equitable interest in its property. 11 U.S.C. § 541(a). That property becomes property of the bankruptcy estate. *Id.* As the property becomes estate property, it comes under control of the trustee. §§ 542-43. Since the trustee and the debtor in possession are typically the same entity in Chapter 11 bankruptcy, the property comes under the control of the debtor in possession. Thus, in the context of Chapter 11, there is a divesture of property, and then the property is again vested back in the debtor. But the debtor is conceptually, although actually, a different entity.

[78] If 11 U.S.C. § 544(a) permits the trustee to avoid interest, so too can the debtor in possession, even though the party now serving as the debtor in possession created the interest.

[79] U.C.C. § 9-302(1)(e). Since Article 9 requires the filing of a financing statement to protect a security interest, failure to file may result in a loss of the security interest. *See supra* notes 71-75 and accompanying text; *see, e.g., In re* Vigil Bros. Constr. Inc., 193 B.R. 513, 520 (B.A.P. 9th Cir. 1996) (failing on part of purchaser of accounts to file financing statement will allow bankruptcy trustee to avoid purchase); *see also In re* Cripps, 31 B.R. 541, 543-44 (Bankr. W.D. Okla. 1983) (deeming failure to file financing statement rendered purchaser of debtor's account receivable subordinate to debtor's Chapter 7 trustee). However, the U.C.C. provides an exception to this rule where the amount of accounts transferred is insignificant. U.C.C. § 9-302(1)(e).

[80] U.C.C. § 9-302(1)(e). In this situation, perfection is said to be automatic.

applicable. Courts faced with determining if this automatic perfection has occurred have used one of the following three tests: (1) a percentage of accounts test; (2) a casual and isolated transaction test; and (3) a test combining these earlier two tests.

First, the percentage of accounts test asks simply, "What percentage of the total accounts of the assignor were assigned and whether that percentage constitutes a 'significant' part of the whole?"[81] Under this test, if the assignment from the originator amounts to a low percentage of the originator's accounts, the SPV may not be required to file a financing statement.[82] In other words, perfection would be automatic.

However, problems arise under this test in determining the percentage that represents a significant portion of the total accounts. Courts have grappled with determining the percentage of assignment required to be significant.[83] To date, there is no clear line to differentiate percentages as either significant or insignificant.[84] The provisions of the U.C.C. do not define

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[81] *In re Vigil Bros. Constr., Inc.*, 193 B.R. at 518 (citation omitted).

[82] *See In re* Klein Glass & Mirror, Inc., 155 B.R. 718, 721 (Bankr. S.D. Tex. 1992) ("an assignment of accounts is exempt from the filing requirement only if it constitutes less than a substantial portion of the debtor's accounts, referred to as the 'percentage test'"); *see, e.g., In re* B. Hollis Knight Co., 461 F. Supp. 1213, 1215 (E.D. Ark. 1978) (finding insignificant assignment of roughly 14% of accounts), *rev'd on other grounds*, 605 F.2d 397 (8th Cir. 1979); *In re* Crabtree Const. Co., 87 B.R. 212, 213 (Bankr. S.D. Fla. 1988) (transferring 14% of debtors overall accounts is insignificant); *In re* Sun Air Int'l, Inc., 24 B.R. 135, 137 (Bankr. S.D. Fla. 1982) (assigning 14% of account receivables not significant); *In re* K & G Health Care Indus., 28 U.C.C. Rep. Serv. (CBC) 837, 841 (Bankr. S.D. Fla. 1979) (holding assignment of 6% of debtor's accounts insignificant); Lehigh Press, Inc. v. National Bank, 389 S.E.2d 376, 379 (Ga. Ct. App. 1989) (deeming transfer of 57% of receivables was significant and required filing).

[83] *See In re* Barrington, 34 B.R. 55, 57-58 (Bankr. M.D. Fla. 1983) (applying casual and isolated test where there had been no clear determination of what is meant by "significant" or "insignificant").

[84] It would seem certain that an assignment of at least forty percent of the originator's accounts would likely not qualify for the exception. *See In re* Vigil Bros. Constr., Inc., 193 B.R. 513, 520 (9th Cir. B.A.P. 1996) (affirming assignment of 40% of outstanding accounts was significant and perfection required filing); *In re* Klein Glass & Mirror, Inc., 155 B.R. 718, 722 (Bankr. S.D. Tex. 1992) (holding assignment of 40% of outstanding accounts receivables represents substantial part); *cf.* CLARK, *supra* note 14, at ¶ 2.07[6] ("If a dealer factors 30 percent of his

either term, therefore, a determination of whether a particular assignment is significant is likely mere supposition. It is an ambiguous question of fact which allows the finder of fact considerable amount of latitude. When arguing that its assignment under the percentage test is insignificant and, thus, is automatically perfected, the SPV is faced with a considerable amount of uncertainty. Nonetheless, the insignificance of the assignment would be an argument that the SPV would be forced to make, as the SPV probably would not prevail if the Court employed either of the remaining tests.

The second test that courts may apply is the casual and isolated test, which considers to the totality of the circumstances surrounding the transaction.[85] No filing is required where "the transaction was not part of a regular course of commercial financing."[86] This test allows a court to consider whether the SPV is in the business of taking assignments[87] and the test used in this determination is founded in Comment 5 to § 9-302 which provides:

> The purpose of the subsection (1)(e) exemption is to save from *ex post facto* invalidation casual or isolated assignments: some accounts receivable statutes were so broadly drafted that all assignments, whatever their character or purpose, fell within their filing provisions. Under such statutes many assignments which no one would think of filing might have been subject to invalidation. The paragraph (1)(e) exemption goes to that type of assignment. Any person who regularly takes assignments of any debtor's accounts should file.[88]

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account on a regular basis, the transaction is probably subject to Article 9 filing.").

[85] *See In re* Tri-County Materials, Inc., 114 B.R. 160, 164 (C.D.Ill. 1990) (looking to "totality of circumstances surrounding the transaction" in determining casual or isolated nature); *see also In re* Barrington, 34 B.R. 55, 57 (Bankr. M.D. Fla. 1983) (lacking clear determination of requisite significant amount, casual and isolated test used).

[86] *Hollis Knight*, 605 F.2d at 401.

[87] *See In re* Padgett, 49 B.R. 212, 215 (Bankr. W.D. Ky. 1985) (finding Bank who took series of assignments over period of time ineligible for automatic perfection).

[88] U.C.C. § 9-302 cmt. 5.

This test specifically prohibits automatic perfection where a party regularly takes assignments of accounts. Where the SPV is an entity created by a commercial or investment bank to service multiple originators, the SPV would regularly take assignments in the regular course of its business. Hence, the exception under the casual and isolated transaction test is unavailable to such an entity.[89]

But what if the SPV is not such a commercial entity? The SPV may, in fact, be created to satisfy one transaction with its only purpose to effectuate one "sale." Indeed, since the SPV would not be in the business of taking assignments, a stronger argument may be made in favor of the exception under the casual and isolated test. Prior to the assignment taken from the originator, the SPV would have taken no assignments. Furthermore, after the assignment the SPV would not have taken any more assignments. Thus, the argument may be made that the assignment was, in fact, isolated.

However, this argument would probably fail. The underpinnings of this test ask whether it would be reasonable to require a party to file a financing statement.[90] In this situation, the Court would probably determine that it is, in fact, reasonable for the SPV to file a financing statement, recognizing that the SPV was created for the very purpose of taking the assignment. Therefore, it likely would be reasonable to require the SPV to file a financing statement and the SPV would be unable to claim the benefits of automatic perfection under the casual and isolated transaction test.

This result would not change if the third test, the "combination" test, is applied. Since the "combination" test relies upon both the percentage test and the casual and isolated test,[91] to

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[89] *See* Valley Bank v. City of Henderson, 528 F. Supp. 907, 914 (D. Nev. 1981) (explaining § 9-302(1)(e) is not applicable to institutional financiers).

[90] *Hollis Knight*, 605 F.2d at 401. "The underlying rationale behind the test appears to be the conclusion that it would not be unreasonable to require a secured creditor to file if he regularly takes assignments of a debtor's accounts, but it would be unreasonable if this was not a usual practice." *Id.*

[91] *Id.* "[I]n determining what is a significant part of the outstanding accounts of the assignor, a court must examine all of the facts and circumstances sur-

fail either the percentage test or the casual and isolated test would be also to fail this third test.[92] Since the SPV probably could not pass the casual and isolated test, it also could not satisfy the requirements of the third test. Therefore, a filing would be necessary under the "combination" test.

Analytically, the SPV's success at claiming the benefits of automatic perfection would seem to rest on the SPV being able to argue persuasively that the causal and isolated test is not applicable to the transaction. Accordingly, the SPV may argue that the plain language of § 9-302(1)(e) prohibits the application of the casual and isolated test. In support of this contention, the SPV could argue that nowhere within the provisions of § 9-302(1)(e) is there a mention that the transfer of accounts must be either casual or isolated.[93] Rather, § 9-302(1)(e) references only transfers of accounts not amounting to "a significant part of the outstanding accounts of the assignor."[94]

Recognizing that the plain language of § 9-302(1)(e) would prohibit the use of the casual and isolated test,[95] the SPV could also argue that the Official Comment merely suggests the purpose of the statute and does not dictate how the statute is to be applied.[96] "[T]he plain language of the statute only exempts from the filing requirement an assignment of accounts which does not assign a significant part of the outstanding accounts of the assignor."[97] Thus, application of either the ca-

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rounding the transaction, including the relative size of the assignment and whether it was casual or isolated." *Id.* at 401-02.

[92] *See In re* Vigil Bros. Constr. Inc., 193 B.R. 513, 520 (B.A.P. 9th Cir. 1996) (reasoning that assignment which represents significant portion of assignor's receivables under percentage test may not also qualify for casual and isolated exemption); *In re* Tri-County Materials, Inc., 114 B.R. 160, 164 (C.D. Ill. 1990) (requiring both percentage test and casual and isolated test be met to satisfy exception); *In re* Fort Dodge Roofing Co., 50 B.R. 666, 669 (Bankr. N.D. Iowa 1985) (applying both tests).

[93] U.C.C. § 9-302(1)(e).

[94] *Id.*

[95] *See* United States v. James, 478 U.S. 597, 604 (1986) (beginning point of statutory interpretation is examination of basic language of statute).

[96] *See In re* Vigil Bros. Constr., Inc., 193 B.R. 513, 520 (B.A.P. 9th Cir. 1996) ("The term 'casual and isolated' was included in the official comment as an interpretation of the purpose of the statute.").

[97] *Id.*

sual and isolated test or the combination test would be inconsistent with the statute. Therefore, the SPV should argue that the percentage test is the prevailing test and the only test applicable in determining the affect of § 9-302(1)(e) on asset securitization.[98]

However, a finding that the percentage test governs the application of § 9-302(1)(e) is of little avail to the SPV unless there is a showing that the SPV's assignment of accounts is, indeed, insignificant. Hence, the SPV should concern itself particularly with the uncertainty associated with this position. Therefore, filing the security interest is crucial to protecting the interest of the SPV and the investors.[99]

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[98] *See id.* (holding that court did not err in using percentage test and that plain language of statute calls for assignment not to represent significant part of assignor's accounts).

[99] The location of the filing and the name in which the interest is filed are both critical since if the financing statement is filed improperly, perfection may not occur. U.C.C. § 9-401(1). The proper place to file is provided by § 9-401. *Id.* However, failure to file in the proper location may not necessarily be fatal to the SPV. Section 9-401(2) of the U.C.C. provides:

> A filing which is made in good faith in an improper place or not in all of the places required by this section is nevertheless effective with regard to any collateral as to which the filing complied with the requirements of this Article and is also effective with regard to collateral any covered by the financing statement against any person who has knowledge of the contents of such financing statement.

U.C.C. § 9-401(2). This section fails to indicate the requisite level of knowledge. Some courts have taken the position that any knowledge of a competing security interest is sufficient to make the erroneous filing effective. *See* Chrysler Credit Corp. v. Bank of Wiggins, 358 So. 2d 714, 717 (Miss. 1978) (holding oral statements were sufficient to give notice of prior perfected security interest despite fact that financing statements had not filed). Conversely, other courts have held that a party's mere knowledge that a competing security interest exists is insufficient knowledge for the erroneously filed financing statement to be effective against that party. However, this heightened requirement may be satisfied and the erroneously filed statement may stand if another party has knowledge of the contents of the erroneously filed financing statement, i.e., the name of the debtor and the type of collateral. *See In re* Mistura, Inc., 705 F.2d 1496, 1498-99 (9th Cir. 1983) (finding knowledge of information in financing statement sufficient to satisfy knowledge requirement of the statute).

Important, however, is the fact that courts do not apply § 9-401 without limitation. For instance, courts have held that the provisions of § 9-401(2) do not apply to multistate filings. *See In re* Nemko, 202 B.R. 673, 678 (Bankr. E.D.N.Y. 1996)

However, filing alone cannot completely protect the interest of the SPV. For instance, since the SPV is an assignee of the originator's interest in the assets, the SPV's interest in the income stream is subject to any claims or defenses that the account obligor may have against the originator.[100] Specifically, § 9-318(1)(a) of the U.C.C. subjects the SPV to claims arising from the contract itself, while § 9-318(1)(b) subjects the SPV to any claim or defense arising apart from the contract that accrues before notification of the assignment.[101] Noticeably, sub-

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(reasoning that § 9-401(2) does not apply to multistate filings)

Similarly, in order to be effective, the financing statement must satisfy the formal requirements provided by § 9-402. Notably, where the originator is a corporation, the financing statement should be in the exact corporate name. U.C.C. § 9-402(7). *But see In re* Mines Tire Co., 194 B.R. 23, 26 (Bankr. W.D.N.Y. 1996) (holding deletion of word "tire" from debtor's name not sufficient to undermine proper perfection); *In re* Paramount Int'l, Inc., 154 B.R. 712, 716 (Bankr. N.D. Ill. 1993) ("Filing under a debtor's trade name is not per se insufficient to perfect a security interest where the trade name is substantially similar to the true legal name of the debtor."); *In re* Thriftway Auto Supply, Inc., 156 B.R. 300, 302 (Bankr. W.D. Okla. 1993) (using trade name not seriously misleading) *aff'd* 159 B.R. 948 (Bankr.W.D. Okla. 1993), *aff'd*, 39 F.3d 1193, 1193 (10th Cir. 1994). Likewise, if the originator is a partnership, then the financing statement should be filed in the name of the partnership. *See* U.C.C. § 9-402(7); *but see* Transamerica Commercial Fin. Corp. v. Blueville Bank, 438 S.E.2d 817, 823 (W. Va. 1993) (holding entity not in compliance with fictitious name statute must file financing statement in name of individual partners).

[100] *See* Harris v. Dial Corp., 954 F.2d 990, 993 (4th Cir. 1992) (allowing account debtor to set off against assignee of account); Security Pac. Bank v. Haines Terminal & Highway Co., 869 P.2d 156, 159 (Alaska 1994) (holding purchaser of collateral was entitled to offset overpayment against amount due).

[101] *See* U.C.C. § 9-318(1). Section 9-318(1) of the U.C.C. provides:

> (1) Unless an account debtor has made an enforceable agreement not to assert defenses or claims arising out of a sale as provided in Section 9-206 the rights of an assignee are subject to
> (a) all the terms of the contract between the account debtor and assignor and any defense or claim arising therefrom; and
> (b) any other defense or claim of the account debtor against the assignor which accrues before the account debtor receives notification of the assignment.

Id.; *see also* First Nat'l Bank v. Thomson Consumer Elecs., Inc., 84 F.3d 397, 401 (11th Cir. 1996) (holding assignee subject to any claims or defenses arising from same transportation agreement); *In re* Metropolitan Hosp., 131 B.R. 283, 290 (Bankr. E.D. Pa. 1991) (finding "right of setoff may be asserted if it arises before notification of the account assignment"); Independent Nat'l Bank v. Westmoor Elec., Inc., 795 P.2d 210, 216 (Ariz. Ct. App. 1990) (explaining that account debtor can

section 1(a) allows the broadest application of the two provisions by not limiting the claims which may be raised against the assignee to those claims arising prior to notification.[102]

More importantly, § 9-318 has been found, in some cases, to impose an affirmative recovery for an account debtor and an affirmative liability against an assignee.[103] Such was the result in *Benton State Bank v. Warren* where progress payments were assigned as collateral for a loan.[104] In *Benton*, the court allowed the account debtor to recover from the assignee a payment that was made prior to the account debtor's discovery that the assignor had breached the parties' construction contract.[105] The court reasoned that, pursuant to § 9-318 of the U.C.C., the assignee cannot retain payments made by mistake unless the assignor can show a change in its position.[106] Recognizing that its holding was not the general rule, the court further reasoned that a determination of whether to allow affirmative recovery must be considered on a case-by-case basis.[107] Although affirmative recovery, as suggested by *Benton*, is the exception rather than rule,[108] nonetheless, it is an ex-

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assert claims and defenses arising from contract regardless of notification, but claims and defenses unconnected to contract may be asserted before notification).

[102] U.C.C. § 9-318(1).

[103] CLARK, *supra* note 14, ¶ 11.04[5][b].

[104] 562 S.W.2d 74, 75 (Ark. 1978). *But see* Michelin Tires Ltd. v. First Nat'l Bank, 666 F.2d 673, 677-78 (1st Cir. 1981) (disallowing affirmative recovery); Gold Circle Stores v. Riveria Fin. East Bay, Inc., 540 F. Supp. 15, 21 (N.D. Cal. 1982) (finding no affirmative right of recovery created by section 9-318); Lawson State Community College v. First Continental Leasing Corp., 529 So. 2d 926, 930-31 (Ala. 1988) (finding § 9-318 does not permit affirmative recovery), *overruled on other grounds by* Berner v. Caldwell, 543 So. 2d 686, 688 (Ala. 1989). Cases allowing such an affirmative recovery recognize the impact of section 9-317 of the U.C.C. which provides: "The mere existence of a security interest or authority given to the debtor to dispose of or use collateral does not impose contract or tort liability upon the secured party for the debtor's acts or omissions." U.C.C. § 9-317. Since an assignee is the equivalent of a secured party in Article 9, this section ultimately prohibits affirmative recovery. *Lawson*, 529 So. 2d at 932.

[105] *Benton*, 562 S.W.2d at 76-77.

[106] *Id.* at 76 (citation omitted).

[107] *Id.* The court noted that the issue requires an exercise of judgement since every case might not compel the same result. *Id.*

[108] *Id.*

ception that the parties to the transaction should consider.

Although it might appear that the application of § 9-318 exposes the SPV and the income stream to harm caused by the originator, this impact may be limited through the use of a "cut-off" clause.[109] Section 9-206(1) of the U.C.C. allows the originator and account debtor to execute such a "cut-off" clause:

> Subject to any statute or decision which establishes a different rule for buyers or lessees of consumer goods, an agreement by a buyer or lessee that he will not assert against an assignee any claim or defense which he may have against the seller or lessor is enforceable by an assignee who takes his assignment for value, in good faith and without notice of a claim or defense, except as to defenses of a type which may be asserted against a holder in due course of a negotiable instrument under the Article on Negotiable Instruments (Article 3). A buyer who as part of one transaction signs both a negotiable instrument and a security agreement makes such an agreement.[110]

Where each of the contingencies of § 9-206(1) are satisfied, the account debtor is prohibited from raising claims or defenses against the SPV.[111] Therefore, the SPV could take the income stream free from the obligor's claims.

However, the mere presence of a "cut-off" clause may not, under all circumstances, prevent an obligor from raising claims or defenses against the SPV. Such may be the common result where the income stream is produced by a services contract, since services contracts involve neither a buyer nor a seller in

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[109] "Cut-off" clauses are frequently described as "hell or high water clauses." Dixie Groceries, Inc. v. Albany Bus. Mach., 274 S.E.2d 81, 83 (1980). However, in the commercial setting these clauses are very rare. Nonetheless, "cut-off" clauses may be very effective in limiting the exposure of the assignee. *See, e.g., In re* O.P.M. Leasing Servs., Inc., 21 B.R. 993, 1006 (Bankr. S.D.N.Y. 1982) (refusing to allow lessee to terminate right of lessor's assignee to receive payments).

[110] U.C.C. § 9-206(1).

[111] Benedictine College v. Century Office Prods., Inc., 853 F. Supp. 1315, 1323 (D. Kan. 1994) ("The only defenses which may be asserted against [assignee] are those 'real' defenses which may be asserted against a holder in due course."); *In re* ICS Cybernetics, Inc., 123 B.R. 467, 477 (Bankr. N.D.N.Y. 1989) (holding that lessee has unconditional obligation to pay because of hell or high water clause), *aff'd*, 123 B.R. 480 (Bankr. N.D.N.Y. 1990).

the traditional sense. Therefore, arguably, the provisions of § 9-206 do not apply to services contracts.

This was the holding of *Suburban Trust & Savings Bank v. University of Delaware*.[112] In *Suburban Trust*, a University entered into an agreement with a vendor whereby the vendor agreed to provide continuous computer services to the University.[113] The contract contained a cut-off clause which stated: "All amounts payable by [the University] under this Agreement shall be absolute and unconditional and shall not be subject to any defense, setoff, counterclaim, or recoupment for any reason whatsoever, and such amounts shall be continue to be payable in all events."[114] As services commenced, the University made its required payments.[115] Thereafter, with the consent of the University, the contract was assigned.[116] In connection with the assignment, the University executed another agreement which contained a clause similar to the cut-off clause contained in the initial services contract.[117] Subsequently, a dispute erupted between the University and the vendor, resulting in the University discontinuing its payments under the contract.[118] The assignee brought suit against the University based upon the assignee's belief that it possessed an enforceable cut-off clause.[119] However, the Court ultimately disagreed.[120]

The court began its analysis by examining the plain language of Delaware's version of § 9-206, noting that the section applies solely to buyers and lessors.[121] Because the contract at

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[112] 910 F. Supp. 1009, 1015 (D. Del. 1995)

[113] *Suburban Trust*, 910 F. Supp. at 1011.

[114] *Id.* at 1011.

[115] *Id.*

[116] *Id.* at 1011-12.

[117] *Id.*

[118] *Suburban Trust*, 910 F. Supp. at 1012. The University contracted with another services provider when it learned that the initial provider had assigned the contract and would no longer be the University's provider of computer services. *Id.*

[119] *Id.*; *see also supra* notes 113-16 and accompanying text.

[120] *Suburban Trust*, 910 F. Supp. at 1016.

[121] *Id.* at 1015. The court in *Suburban Trust* considered Delaware's version of the U.C.C., which is identical to that of the U.C.C. *Id.*

issue involved services, the University was neither a buyer nor a lessor.[122] Therefore, the court reasoned that the plain language of § 9-206 prevented the cut-off clause from being enforced against the University.[123]

However, this determination did not conclude the court's analysis. The assignee argued that § 9-206 was not the only source of cut-off clauses, but that parties may, pursuant to the freedom of contract provisions of § 1-102(3),[124] enter into an agreement to waive claims and defenses.[125] The assignee argued that because the University, in good faith and at arms length, agreed to the term limiting its defenses, the University should be precluded from raising any claim or defense against the assignee.[126] Again, however, the Court disagreed.[127]

The Court reasoned that throughout the U.C.C., most notably in sections 2-210,[128] 2-306,[129] 9-112,[130] and 9-203,[131]

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[122] *Id.* at 1015.

[123] *Suburban Trust*, 910 F. Supp. at 1016. Although the court considered alternatives interpretations, precedent required the court to follow the plain meaning of the statute. *Id.*

[124] Section 1-102(3) states:

> The effect of provisions of this Act may be varied by agreement, except as otherwise provided in this Act and except that the obligations of good faith, diligence, reasonableness and care prescribed by this Act may not be disclaimed by agreement but the parties may by agreement determine the standards by which the performance of such obligations is to be measured if such standards are not manifestly unreasonable.

U.C.C. § 1-102(3).

[125] *Suburban Trust*, 910 F. Supp. at 1016.

[126] *Id.*

[127] *Id.* at 1018.

[128] U.C.C. § 2-210. Section 2-210(1) of the U.C.C. provides: "A party may perform his duty through a delegate *unless otherwise agreed* . . . ." U.C.C. § 2-210(1) (emphasis added). In addition, § 2-210(2) states: "*Unless otherwise agreed* all rights of either seller or buyer can be assigned . . . ." U.C.C. § 2-210(2) (emphasis added).

[129] U.C.C. § 2-306(2). Section 2-306(2) provides: "A lawful agreement by either the seller or the buyer for exclusive dealing in the kind of goods concerned imposes *unless otherwise agreed* an obligation by the seller . . . ." U.C.C. § 2-306(2) (emphasis added).

[130] U.C.C. § 9-112. Section 9-112 states: "*Unless otherwise agreed*, when a secured party knows that the collateral is owned by a person who is not the debtor, the owner of the collateral is entitled to receive from the secured party any surplus . . . ." U.C.C. § 9-112 (emphasis added).

[131] U.C.C. § 9-203(3). Section 9-203(3) provides "*Unless otherwise agreed* a secu-

the drafters utilized the provision "unless otherwise agreed."[132] Employing these statutes, the parties were free to agree outside of the provisions of the U.C.C.[133] However, no such provision existed in either § 9-318 or § 9-206.[134] Therefore, the plain language of the statutes allowed for cut-off clauses in only one instance: where the cut-off clause is executed under § 9-206.[135]

Because the provisions in Article 9 were more specific, those provisions controlled over the general provisions of § 1-102(3).[136] Since Article 9 provided no other exceptions, the parties could not agree to a cut-off clause apart from § 9-206.[137] Hence, a cut-off clause must satisfy the requirements of § 9-206 in order to be enforceable.[138]

Although the decision in *Suburban Trust* is limited to Delaware,[139] its import may reach beyond that state. As a matter of jurisprudence, most states follow the plain meaning rule. Although the result of *Suburban Trust* has been criticized,[140] the holding in *Suburban Trust* is clearly consistent

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rity agreement gives the secured party the rights to proceeds provided by Section 9-306." U.C.C. § 9-203(3) (emphasis added).

[132] *Suburban Trust*, 910 F. Supp. at 1017.

[133] *Id.*

[134] *Id.* at 1017-18. The court relied upon Comment 2 to § 2-201 in determining the statutory authority for "[v]ary by agreement" provisions. *Id.* at 1017.

[135] *Id.* at 1016.

[136] *See, e.g.*, Lenoir v. Madison County, 641 So. 2d 1124, 1128 (Miss. 1994) (explaining terms of specific statute control terms of general statute); Wilbourn v. Hobson, 608 So. 2d 1187, 1191 (Miss. 1992) (noting general statute is controlled by specific statute when both statutes encompass same subject matter).

[137] *Suburban Trust*, 910 F. Supp. at 1016.

[138] *Id.*

[139] *Suburban Trust* was decided by the district court through its application of Delaware law. *Id.* at 1013.

[140] CLARK, *supra* note 7, at ¶ 11.04[4]. One commentator noted:

> The Delaware Court's decision creates a double standard in the U.C.C. If the obligor on a service contract signs a promissory note and the note is negotiated to a holder in due course, it is enforceable notwithstanding any defense. Similarly, under Article 2A, governing equipment leases, full effect is given to cutoff and 'hell or highwater' clauses. Why should the rule be different just because the transaction is within the scope of Article 9 and involves a service contract?

with the plain meaning rule. The language of § 9-318 plainly provides one exception to the general rule that claims and defenses asserted against an assignor of a contract may be asserted against its assignee.[141] That one exception is stated in § 9-206, but clearly applies only to buyers and lessees and not to services.[142] There is no ambiguity.

To argue that a hidden exception exists that is not otherwise listed in either § 9-206 or § 9-318, would be inconsistent with the plain meaning rule and inconsistent with state law. However, the U.C.C., as adopted by the various states, is neither independent of state law nor does it "co-exist" with state law. Rather, the U.C.C. is subsumed by the laws of the adopting state. It is a "part of" the laws of the adopting state. Thus, in adopting the U.C.C., a state may modify provisions as it chooses.[143] Notably, the application of the plain meaning rule is simply another modification applied by a particular state.

Suburban Trust appears consistent with the plain meaning

Id. However, this criticism may be overstated. Article 3 does prohibit the obligor on a negotiable instrument from raising certain defenses against either a holder in due course or the holder of an instrument who was transferred the instrument from a holder in due course. *See* U.C.C. § 3-203(b) (describing the shelter doctrine). Qualifying as a holder in due course eliminates the possibility of being affected by the "personal" defenses to the note. However, the holder in due course is not completely immune. Certain defenses, the real defenses, may always be raised against the holder in due course. U.C.C. § 3-305(2). Real defenses include:

> (a) infancy, to the extent that it is a defense to a simple contract; and
> (b) such other incapacity, or duress, or illegality of the transaction, as renders the obligation of the party a nullity; and
> (c) such misrepresentation as has induced the party to sign the instrument with neither knowledge nor reasonable opportunity to obtain knowledge of its character or its essential terms; and
> (d) discharge in insolvency proceedings; and
> (e) any other discharge of which the holder has notice when he takes the instrument.

Id. Thus, to the extent that a double standard exists, it is limited.

[141] U.C.C. § 9-318.

[142] *Id.*

[143] Thus, some states, namely California, Hawaii, Louisiana, Illinois and Idaho, have expanded Article 9 to include consensual security interests in deposit accounts. Furthermore, some states require a financing statement to include either an individual debtor's social security number or, if the debtor is a business, its federal employer identification number.

rule. However, this decision may be short lived since the drafters of revised Article 9 have noted the glitch found in § 9-206. These drafters will likely remedy the problem illuminated in *Suburban Trust* by expanding the scope of the section. Revised § 9-206 will apply to all account debtors, and once this is adopted by the individual states, will eliminate the problems posed by *Suburban Trust*.[144] Until then, a strong argument may be made that cutoff clauses are inapplicable in service contracts, based on the plain meaning of § 9-318.[145]

Inability to separate the income stream from the obligor may also result where the originator has become insolvent and the SPV's interest in an account has become commingled with that of the originator's.[146] Once commingled in a deposit account, the funds are presumed to be property of the bankruptcy estate.[147] Since the commingled accounts are connected to the originator through the bankruptcy estate, the very structure of asset securitization is undermined. This risk increases where the transaction is structured as a divisible interest.[148] Howev-

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[144] However, even with the revision of Article 9, such cutoff clauses are not allowed in consumer credit transactions. Hence, in these transactions, the assignee takes the income stream subject to all of the claims and defenses which may be asserted against the assignor. Therefore, in consumer transactions, there exists the real possibility of exposure resulting from the originator's behavior.

[145] *See supra* notes 138-45 and accompanying text.

[146] In this situation, section 9-306(4)(d) of the U.C.C. applies. U.C.C. § 9-306(4)(d).

[147] *See In re* Bullion Reserve of N. Am., 836 F.2d 1214, 1217 (9th Cir. 1988) (finding commingled funds constitute property of debtor's estate).

[148] Schwarcz, *supra* note 1, at 262. The risk of commingling is heightened in a divisible interest structure, particularly where the SPV and the originator negotiate for the SPV to receive an amount in excess of a designated amount.

In "classic" asset securitization, the originator sells its entire interest in the pooled assets. *Id.* at 255. However, where the divisible interest transaction is employed, the originator only sells a fractional interest in the assets up to a specific point termed the "trigger point." *Id.* at 265. The originator purges itself of all interest in collections up to this point and, possibly, a "percentage of collections above the trigger point." *Id.*

The use of the divisible interest, then, is merely a partial assignment of an account in the sense that the originator has not relinquished the right to receive all collections from the entire pooled asset. Notably, the originator's ability to sell only a fraction of the pooled asset minimizes the effect of over-collateralization, which is the SPV's obtainment of an excess of receivables so as to allay investor's

er, where any commingling occurs, whether through more traditional securitization or securitization using the divisible interest, the end result is the same: in the event of bankruptcy, the income stream becomes part of the bankruptcy estate.

However, like the other risk associated with separation failure, commingling may be mitigated, if not eliminated all together. Although securitization, unlike factoring, occurs on a non-notification basis, the transaction may be structured to utilize a third party servicer.[149] Where this system is used, the account debtors would send their payments directly to the third party servicer who would then separate the collections and place the collections in separate accounts. Hence, the proceeds would remain identifiable and would not be commingled.

However, even where the proceeds are commingled, if the SPV can ultimately trace its proceeds, its interest may nonetheless be protected. The act of commingling is not the event

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fears of losses. *Id.* at 261.

In the classic structured finance transaction, the originator may attempt to minimize the effect of overcollateralization by using not one, but two SPV's. Schwarcz, *supra* note 1, at 265. Under this scenario, the originator transfers assets to the first SPV using a true sale in order to shield the assets from bankruptcy. *Id.* However, the first SPV does not issue securities to fund the purchase, but instead transfers the acquired income streams to the independent second SPV. *Id.* This transfer is sale for accounting purposes, but may not also constitute a sale for bankruptcy purposes. *Id.* The second SPV then issues securities to fund the purchase. *Id.* After the securities have been paid off, the second SPV transfers the income streams back to the first SPV. *Id.* Finally, the first SPV merges with the originator. Schwarcz, *supra* note 1, at 265. Through this cumbersome process, the cost of over-collateralization is minimized. *Id.*

Because the originator in a divisible interest structure sells only the fraction of the income stream that the originator is confident it can collect, the often onerous effects of over-collateralization are minimized. In addition, the transaction costs associated with securitization are reduced. *Id.* at 266. More importantly, smaller organizations are provided access to the marketplace and are able to partake in the various benefits associated with asset securitization. *Id.* However, difficulties may arise because the originator may be unable to segregate its interest in the income stream from the originator's. Unable to segregate its interest, commingling may occur.

[149] Even the originator may serve as the third party servicer. However, where this occurs the originator should be adequately compensated in order to offset the cost of over-collateralization. More importantly, payment reduces concerns that the originator is retaining control over the assets. However, where it appears that the originator is still in control of the property, a basis for substantive consolidation exists.

which causes the SPV to lose its interest. Rather, the interest of the SPV is lost where the SPV can no longer trace its interest in the income stream. Thus, pursuant to the provisions of § 9-306(4)(d), the SPV may limit the effect of commingling if the SPV can trace its proceeds.[150] Under this provision, the SPV's interest is "limited to an amount not greater than the amount of any cash proceeds received by the debtor within ten days before . . . insolvency."[151] However, this limitation is lost where the SPV cannot trace its interest into the account;[152] "if the creditor cannot trace the . . . collateral into the bank account as proceeds, it cannot claim them in the first place and its rights are not suddenly expanded by the 10 day rule."[153] Therefore, identification is essential.

Although use of a third party servicer who turns payments over to the SPV within ten days of receipt effectively eliminates the risk associated with § 9-306 4(d)(ii), the third party servicer may also reduce the remote risk associated with § 9-306 4(d)(i). Section 9-306(4) provides:

> In the event of insolvency proceedings instituted by or against a debtor, a secured party with a perfected security interest in proceeds has a perfected security interest only in the following proceeds:
> (d) in all cash and deposit accounts of the debtor in which proceeds have been co-mingled with other funds, but the perfected security interest under this paragraph (d) is
> (i) subject to any right to set-off.[154]

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[150] U.C.C. § 9-306(4)(d).

[151] U.C.C. § 9-306(4)(d)(ii); *see also* First Nat'l Bank v. Martin, 48 B.R. 317, 320 (S.D. Tex. 1985) (refusing to permit creditor greater claim prior to statutory time limit even if proceeds are identifiable); *In re* Barkley, 31 B.R. 924, 927 (Bankr. W.D. Mich. 1983) (noting statute dictates perfected security interest lasts ten days).

[152] *In re* Datair Sys. Corp., 42 B.R. 241, 245 (Bankr. N.D. Ill. 1984) (stating that creditor cannot claim benefits of § 9-306(2) where proceeds no longer identifiable).

[153] CLARK, *supra* note 14, ¶ 6.03[4][b]. More important is that under this section, where no deposits are made within the 10 days prior to insolvency and commingling has occurred, the interest of the SPV is terminated.

[154] U.C.C. § 9-306(4)(d)(i).

The potential harm caused by the application of this section is that a court may interpret it as creating a special priority to a lender who is able to exercise its right to set-off against the commingled account.[155] In this event, the lender may prime the SPV's interest in the account. However, as of yet, no court has found that such a special priority exists.[156] In any event, where a third party servicer is used, the risk associated with this subsection, however minute it may be, may eliminate the contingency completely.

III. THE ASSIGNMENT OF CLAIMS ACT

The Uniform Commercial Code is not the sole risk associated with the inability to separate the income stream from the originator. Where the obligor of the income stream is the federal government, parties must not only consider the U.C.C., but also must be cognizant of the application of the Assignment of Claims Act [hereinafter ACA].[157]

The ACA allows contracts to be assigned where the federal government is an obligor.[158] Thus, income streams produced

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[155] CLARK, *supra* note 14, ¶ 6.03[4][d].

[156] Such a reading of § 9-306(4)(d)(i) would likely be contrary to the plain language of the statute. The section clearly fails to indicate that any "special" right is being created. Rather, the statute uses the phrase "subject to *any* right." Key to this phrase is the presence of the adjective "any." Since the U.C.C. does not define the term, "any" is defined using common terms. "Any", the adjective, is defined as " one, some, or all indiscriminately of whatever quantity." WEBSTER'S NEW COLLEGIATE DICTIONARY 51 (1973). Reading this definition of "any" within the section would indicate that no right is being created, but that the right of set-off is merely being preserved.

[157] 31 U.S.C. § 3727; 41 U.S.C. § 15. Prior to the ACA, a policy existed against the transfer of claims against the federal government. Cypel, *supra* note 42, at 1212-13. This policy changed with the enactment of the Assignment of Claims Act of 1940.

[158] Even with the passage of the ACA, there was some question regarding health care receivables. Specifically, 42 U.S.C. § 1396a(a) (requirements for medicaid plans) and 42 U.S.C. § 1395g(c) (requirements for medicare) are frequently referred to as "anti-assignment" provisions. Both of these provisions prohibit payments to be made to parties other than to providers. However, this is a misnomer. These provisions simply prohibit payment to any party other than the provider. Thus, these receivables could be pledged. *See In re* Missionary Baptist Found. of Am., 776 F.2d 752, 756-59 (5th Cir. 1986) (concluding Social Security

by government entities may be sold like any other income stream.[159] However, the ACA also places certain limits on the ability of the originator to separate itself from the asset.

In addition to the perfection requirements found in the U.C.C., the ACA has its own independent perfection requirements.[160] These requirements are found at either 31 U.S.C. § 3727(c),[161] which relates to the assignment of claims for work already completed, or 41 U.S.C. § 15,[162] which relates to

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Act may permit receivables to be used in financing); *In re* American Care Corp., 69 B.R. 66, 67 (Bankr. N.D. Ill. 1986) (allowing security interest in medicare payments).

[159] 31 U.S.C. § 3727(c); 41 U.S.C. § 15. 31 U.S.C. § 3727(c) provides:

> Subsection (b) of this section does not apply to an assignment to a financing institution . . . when—
> (1) the contract does not forbid an assignment;
> (2) unless the contract expressly provides otherwise, the assignment—
> (A) is for the entire amount not already paid;
> (B) is made to only one party, except that it may be made to a party as agent or trustee for more than one party participating in the financing; and
> (C) may not be reassigned; and
> (3) the assignee files a written notice of the assignment . . . .

31 U.S.C. § 3727(c).

[160] 31 U.S.C. § 3727(c); 41 U.S.C. § 15.

[161] *See supra* note 151.

[162] Section 15(b) provides:

> The provisions of subjection (a) of this section shall not apply in any case in which the moneys due or to become due from the United States or from any agency . . . under a contract providing for payments aggregating $1,000 or more . . . provided:
> (1) . . . no claim shall be assigned if it arises under a contract which forbids such assignment.
> (2) That, unless otherwise expressly permitted by such contract, any such assignment shall cover all amounts payable under such contract and not already paid, shall not be made to more than one party, and shall not be subject to further assignment, except that any such assignment may be made to one party as agent or trustee for two or more parties participating in such financing.
> (3) That, in the event of any such assignment, the assignee thereof shall file written notice of the assignment together with a true copy of the instrument of the assignment with—
> (A) the contracting officer or the head of his department or agency;
> (B) the surety or sureties upon the bond or bonds, if any, in connection with such contract; and

the assignment of executory contracts. Perfection under either identical section is completed by giving the government proper notice of the assignment. With proper notice, the process of separation begins.[163]

Although notice initiates the process of separation, separation may not be effectuated completely. In addition to the express provisions regarding separation, certain implied requirements also exist.[164] One implied requirement is that the proceeds of the assignment be used in, or at least made available for, work on government contracts.[165] In order for the SPV to protect itself from the application of this implied requirement, the SPV should have no reason to know, prior to its purchase of the income stream, that the proceeds from the sale may not be used by the originator in completing the government contract. Failing this, the assignment could not be perfected.

More problematic is the fact that the SPV takes the assignment of the income stream subject to any claims or defenses which the federal government may assert against the assignor.[166] Similarly, the federal government may also exercise its right associated with claims that are unrelated to the agreement underlying the assigned income stream and prior to

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(C) the disbursing officer, if any, designated in such contract to make payment.

41 U.S.C. § 15(b).

[163] However, failure to perfect under the ACA may not be fatal. Cases have held that an assignment, otherwise perfected under state law, is still valid between the parties. Arthur Pew Constr. Co. v. Lipscomb, 965 F.2d 1559, 1576 (11th Cir. 1992). "The assignment statutes are for the protection of the government. They do not regulate the rights of parties to the assignment. Whether or not an assignment is valid as against the United States, it is effective and binding on the parties." *Arthur Pew*, 965 F.2d at 1576.

[164] Cypel, *supra* note 42, at 1215-17.

[165] *See, e.g.*, First Nat'l City Bank v. United States, 548 F.2d 928, 934-35 (Cl. Ct. 1977) (holding plaintiff not bona fide assignee under ACA where funds advanced by virtue of assignment not used in performance of government contract); *cf.* American Nat'l Bank & Trust Co. v. United States, 22 Cl. Ct. 7, 16 (Cl. Ct. 1990) (stating no valid assignment where funds not loaned for or made available for performance of government contract).

[166] 48 C.F.R. §32.803(e) (1989). "[T]he Government may apply against payments to the assignee any liability of the [assignor] to the Government . . . if the liability existed at the time notice of the assignment was received." 48 C.F.R. 32.803(e); *cf.* U.C.C. § 9-318 (taking subject to claims and defenses).

notification. Thus, where the federal government is the obligor, the income stream may not separate from the originator.

However, this result is not mandated. A federal entity, like any commercial entity, may exercise a waiver or cutoff clause called a "no setoff commitment."[167] This commitment provides that the government cannot reduce its payment obligation for any of the contractor's liabilities that arise independently of the contract and for any selected liabilities that are contract related. Where the federal entity exercises this commitment, separation may result.

Thus, where the United States is the obligor, the SPV must concern itself with more than the U.C.C. It must concern itself with the A.C.A. Without compliance with both, the SPV may further compromise the interest of its investors.

IV. THE FTC AND CONSUMER CREDIT TRANSACTIONS

Unlike any other impairment caused by the U.C.C. or any other federal law, the FTC has played the largest role in negating separation of the originator from the income stream. This is accomplished primarily through the application of 16 C.F.R. § 433.2.[168] Pursuant to this regulation, anytime consumer credit is issued, the SPV must take the purchased income

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[167] 48 C.F.R. § 32.803(d). The Federal Agency can use "a no-setoff commitment" only in certain circumstances such as during wartime or a national emergency. 48 C.F.R. § 32.803(d).

[168] This regulation provides:

> In connection with any sale or lease of goods or services to consumers . . . it is an unfair or deceptive act or practice within the meaning of section 5 of that Act for a seller, directly or indirectly, to
> (a) Take or receive a consumer credit contract with the following provision . . . :
>
> ANY HOLDER OF THIS CONSUMER CREDIT CONTRACT IS SUBJECT TO ALL CLAIMS AND DEFENSES WHICH THE DEBTOR COULD ASSERT AGAINST THE SELLER OF GOODS OR SERVICES OBTAINED PURSUANT HERETO OR WITH THE PROCEEDS HEREOF. RECOVERY HEREUNDER BY THE DEBTOR SHALL NOT EXCEED AMOUNTS PAID BY THE DEBTOR HEREUNDER.

16 C.F.R. § 433.2 (1996).

stream subject to any claim which may be made against the originator.[169] Therefore, cutoff clauses are completely unenforceable.[170]

However, limitations are placed on the obligor's ability to recover. In consumer transactions, the exposure of the SPV is limited to the amount paid by the borrower.[171] In addition, courts have placed limitations upon a consumer seeking affirmative recovery from the assignee.[172] Cases so holding do so on the basis of the Official Comment to 16 C.F.R. § 433.2 which provides: "Consumers will not be in a position to obtain an affirmative recovery from a creditor, unless they have actually commenced payment and received little or nothing of value from the seller."[173] Thus, the majority of cases deciding the issue have been in line with the Official Comment.[174]

The function of 16 C.F.R. § 433.2 "is to allow consumers to

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[169] 16 C.F.R. § 433.2(b). A consumer is defined as "a natural person who seeks or acquires goods or services for personal, family, or household use." 16 C.F.R. § 433.1(b) (1975).

[170] The best protection in the consumer context is to simply purchase the paper with recourse. CLARK, *supra* note 14, ¶ 12.05[10]. However, as securitization must be done without recourse, this alternative is not acceptable.

[171] Michael M. Greenfield & Nina L. Ross, *Limits on a Consumer's Ability to Assert Claims and Defenses Under the FTC's Holder In Due Course Rule*, 46 BUS. LAW 1135, 1138 (1991).

[172] *See* Ford Motor Credit Co. v. Morgan, 536 N.E.2d 587, 590 (Mass. 1989) (holding that affirmative recovery is inappropriate under section 9-318); *see also* Michelin Tires Ltd. v. First Nat'l Bank, 666 F.2d 673, 679 (1st Cir. 1981) (finding no affirmative recovery intended based upon statutory language of section 9-318); Patton v. McHone, 822 S.W.2d 608, 618 (Tenn. Ct. App. 1991) (stating assignee not independently liable for nonperformance on part of assignor); Home Sav. Ass'n v. Guerra, 733 S.W.2d 134, 136 (Tex. 1987) (concluding that assignee would be absolute insurer if affirmative recovery permitted).

[173] Preservation of Consumers' Claims and Defenses, Final Regulations, Proposed Amendment and Statement of Basis and Purpose, 40 Fed. Reg. 53,527 (1975) (to be codified at 16 C.F.R. § 433.2).

[174] *See In re* Hillsborough Holdings Corp., 146 B.R. 1015, 1021 (Bankr. M.D. Fla. 1992) (relying on Official Comment in finding debtors not entitled to affirmative recovery and interpreting 16 C.F.R. § 433.2(a) to limit amounts paid pursuant contract); Eachen v. Scott Hous. Sys., Inc., 630 F. Supp. 162, 164-65 (M.D. Ala. 1986) (noting F.T.C. provides for limited amounts of affirmative recovery premised on the regulatory history of 16 C.F.R. § 433.2); Felde v. Chrysler Credit Corp., 580 N.E.2d 191, 196 (Ill. App. Ct. 1991) (stating affirmative recovery only allowed to refund money paid under assigned account if breach of contract giving rise to action was so substantial that damages are justified under state law).

stop payments, and, in limited circumstances, . . . where equity requires, to provide for a return of monies paid."[175] To provide otherwise would be to place the assignee in a position as absolute insurer or guarantor of the seller's performance.[176] However, where the obligor is able to recover affirmatively from the assignee, that recovery does not include claims for punitive damages or attorney fees since such claims may not be raised affirmatively.[177]

Undoubtedly, the SPV is exposed to risk where consumer credit is involved. However, some limitations exist regarding recovery. Nonetheless, participants of these assets should note that the potential for exposure does exist.

V. BANKRUPTCY.[178]

The underlying purpose of the separation of the income stream is to allow the income stream to provide the sole basis of financing. Therefore, theoretically, the financial condition of the originator becomes irrelevant. However, notwithstanding separation, the financial instability of the originator may still disrupt the income stream. This result is most evident with the potential of bankruptcy by the originator. The equitable doctrine of substantive consolidation may operate to bring the income stream back into the originator's possession. Likewise, if the transaction is not structured as a true sale, the asset

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[175] *Morgan*, 536 N.E.2d at 590.

[176] *Michelin Tires*, 666 F.2d at 679-80; *see also Guerra*, 733 S.W.2d at 136.

[177] Hardeman v. Wheels, Inc., 565 N.E.2d 849, 851-53 (Ohio Ct. App. 1988). The assignee is not subject to claims and defenses which encompass penalties specifically designed to be assessed against the assignor. *Hardeman*, 565 N.E.2d at 853.

[178] Apart from the risk associated with the failure of a true sale, is the risk associated where the source of the income stream is an executory contract. Pursuant to 11 U.S.C. § 365(a), the trustee, or debtor-in-possession, may reject any executory or unexpired lease. 11 U.S.C. § 365(a). Once rejected, the contract terminates and represents a breach as of the petition date. Where this occurs, the obligor has a claim for damages caused by the breach. More importantly, the SPV loses its interest in the income stream. Thus, although not specifically addressed by this article, the SPV, and the investors, should need to be aware that if their income stream is produced from an executory contract, once in bankruptcy, that income stream may be lost.

may become part of the originator's bankruptcy estate, seriously impairing the interests.

A. Substantive Consolidation.

Nowhere within the provisions of the bankruptcy code is the term "substantive consolidation" found. The reason is simple: this process does not exist in law. Rather, its roots are found in equity.[179] Where substantive consolidation occurs, legally separate entities are merged so that the assets and liabilities of the two become the assets and liabilities of one, single entity.[180] Substantive consolidation in the context of securitization would result in the income stream being subsumed by the originator's bankruptcy estate.

Although the court's authority to order substantive consolidation is certain, the factors used to determine when substantive consolidation is appropriate vary and are applied on a case by case basis.[181] However, common to every case is the determination that the merged entities are not independent. Thus, critical is the fact that the SPV is structured independent of the originator.

Analyzing the application of substantive consolidation, one must note that substantive consolidation is generally applied when one entity is the alter ego of another.[182] However, in

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[179] 11 U.S.C. § 105(a). This equitable process is provided in 11 U.S.C. § 105(a): "The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." *Id.*

[180] F.D.I.C. v. Colonial Realty Co., 966 F.2d 57, 58 (2d Cir. 1992) (acknowledging that "[s]ubstantive consolidation usually results not only in the pooling of assets and liabilities of two or more entities, but also in 'satisfying liabilities from the resultant common fund . . . .'"); Eastgroup Properties v. Southern Motel Ass'n, 935 F.2d 245, 248 (11th Cir. 1991) (explaining substantive consolidation); *In re* Augie/Restivo Baking Co., 860 F.2d 515, 518 (2d Cir. 1988) (describing aspects of substantive consolidation).

[181] *See* Committee, *supra* note 1, at 560.

[182] *See, e.g., In re* Cooper, 147 B.R. 678, 683 (Bankr. D.N.J. 1992) (describing similarities between substantive consolidation and piercing the corporate veil, noting alter ego exists in both); *In re* Moran Pipe & Supply Co., 130 B.R. 588, 591 (Bankr. E.D. Okla. 1991) (ruling that one combined entity results when corporation acts as alter ego of another legal entity): *In re* I.R.C.C., Inc., 105 B.R. 237, 242 (Bankr. S.D.N.Y. 1989) (describing substantive consolidation based upon finding of alter ego).

certain situations, courts have also ordered consolidation where the distinction between the entities has become obscured.[183] Furthermore, consolidation may also be ordered where it would improve the debtor's chance of reorganization.[184]

In structuring the SPV, care should be taken to ensure that the SPV is truly independent. Failing to do this may fatally weaken the transaction by laying the groundwork for substantive consolidation.

B. "True Sale" Issues

In order to separate the income stream from the underlying originator, the sale must be structured as a "true sale."[185] If a true sale occurs, then pursuant to 11 U.S.C. § 541, the originator would no longer have any interest in the stream.[186] Therefore, barring substantive consolidation, the income stream would be left unmolested by the originator's bankruptcy. On the other hand, where a true sale is incomplete, the income stream would become property of the originator's bankruptcy estate.[187] Hence, the income stream could be impaired.

Like substantive consolidation, whether a "true sale" has occurred is fact specific.[188] The Court must look to the rele-

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[183] Chemical Bank N.Y. Trust Co. v. Kheel, 369 F.2d 845, 847 (2d Cir. 1966). The court found that it was not beyond a court's equity powers to order consolidation when the interrelationship of groups is substantially obscured. *Kheel*, 369 F.2d at 847.

[184] *In re* Manzey Land & Cattle Co., 17 B.R. 332, 338 (Bankr. D.S.D. 1982). However, substantive consolidation is only used in this context where no harm or prejudice will befall any particular group or when the harm that will occur is outweighed by the benefits. *Manzey Land*, 17 B.R. at 338.

[185] Cypel, *supra* note 42, at 1204. If a "true sale" is not effectuated, the court may deem the assets merely collateral for a loan and not separate from the originator. *Id.*

[186] 11 U.S.C. § 541. Property of the estate includes all of a debtor's legal and equitable interest in property. *Id.* If the income stream is considered to be property of the estate, then payment may be stated in accordance with the provisions of 11 U.S.C. § 362. 11 U.S.C. § 362 (regarding automatic stay). Moreover, the SPV's interest in the income stream may be primed by operation of 11 U.S.C. § 363. 11 U.S.C. § 363.

[187] Cypel, *supra* note 42, at 1204.

[188] *Id.* Courts apply a balancing test, weighing the "practices, objectives, activities, and overall relationship of the seller and purchaser of the assets." *Id.*

vant state law of the originator to make this determination. The primary issue in this determination, notwithstanding the form of the transaction, becomes whether the parties intended to create a security interest rather than a sale of the assets. Thus, the labels placed on the transaction by the parties are not controlling.[189]

In making the "sale" determination, courts often look to the amount of recourse in the transaction. Recourse refers to the extent to which the SPV bears the risk of loss with respect to the asset being transferred. The greater the ability of the SPV to chargeback or adjust the purchase price, the greater the probability that the transfer will appear to be a security interest. More importantly, the greater the recourse found by the SPV, the greater the probability the income stream will be found to be part of the originator's bankruptcy estate.[190]

Another factor of a true sale and one which is closely related to recourse is the "benefits of ownership." This factor relates to the ability of the originator to recapture the cost of over-collateralization. Benefits of ownership describe the ability of the SPV to transfer back to the originator the amount of the income stream collected above the purchase price. Where no true sale results, the originator would retain the benefits of ownership. However, if a true sale has occurred, the benefits of ownership should pass to the SPV. Accordingly, in a true sale,

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[189] The form of the transaction will not be disregarded unless the elements in favor of the recharacterization substantially outweigh those factors which argue for respecting the form in which the transaction is cast. *In re* Bevill, Bressler & Schulman Asset Management Corp., 67 B.R. 557, 586 (D.N.J. 1986).

[190] If this occurs, the SPV will likely be found to hold a security interest. Thus, the SPV's interest will not be completely lost, but simply impaired. However, this result would depend on the particular jurisdiction, since in certain jurisdictions, in order to create a security interest, formal words of grant may be required. *See* Barth Bros.v. Billings, 227 N.W.2d 673, 678 (Wis. 1975) (holding specific words of grant required to create security interest). Thus, even though the SPV attempted to perfect its assignment, in these jurisdictions, perfection was incomplete. In addition, attachment had not yet occurred. Before a security interest is perfected, it must first attach. *See* U.C.C. § 9-303(1) (stating "A security interest is perfected when it has attached . . . "). Without attachment, and therefore perfection, the trustee, or debtor in possession, may completely avoid the transfer. 11 U.S.C. § 544. Therefore, the income streams would be lost and inure to the benefit of the originator's unsecured creditors.

the originator should not have any control over the asset.

These are but two factors considered in this determination, although these factors are likely the most significant and consistent with the provisions of Article 9. However, at least one jurisdiction has held that even where the account is sold outright, the sold accounts are still part of the assignor's bankruptcy estate.[191]

VI. FORFEITURE

Participants in asset securitization should be aware of the possibility that the income stream may be the result of criminal activity. The transaction may be an attempt by the originator to give its illegitimate operations legitimacy. If this occurs, separation may fail to occur notwithstanding the SPV's purchase of the income stream and the SPV's prompt perfection. This may occur where the income streams become subject to forfeiture to the United States government.

The statutory authority allowing the government to forfeit certain assets is codified in various statutes. The most commonly used are 21 U.S.C. § 853 and § 881, and 18 U.S.C. § 981 and § 982.[192] In the criminal context, 21 U.S.C. § 853 and § 881 apply to narcotics trafficking.[193] Similarly, 18 U.S.C. § 981[194] and § 982[195] provide for forfeiture in a wide range of

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[191] Octagon Gas Sys. v. Rimmer, 995 F.2d 948, 956 (10th Cir. 1993). The decision is premised upon the fact that Article 9 treats the purchased account like as a security interest. Rimmer, 995 F.2d at 955. However, this decision has been severely criticized. CLARK, *supra* note 14, ¶ 6.08. Most notably, the Court did not recognize that the U.C.C. does, in fact, recognize the outright sale of an account. *Rimmer*, 995 F.2d at 954-56; *see, e.g.*, U.C.C. §§ 1-201(37) (1974), 9-102(1)(b) (1972), 9-105(1)(c) (1996), 9-105(1)(m) (1996), 9-504 (1972).

[192] *See id.* 21 U.S.C. § 853 (1994); 21 U.S.C. § 881 (1994); 18 U.S.C. § 981 (1994); *see* 18 U.S.C. § 982 (1992).

[193] *See* 21 U.S.C. §§ 853, 881.

[194] 18 U.S.C. § 981. This section applies to civil forfeiture. *Id.* Civil forfeiture is initiated against the property itself, therefore, the action is in rem. *Id.* In civil forfeiture, the government need only establish probable cause that the property was involved in illicit activities. *Id.*

[195] 18 U.S.C. § 982. This section applies to criminal forfeiture. *See* 18 U.S.C. § 982. In criminal forfeiture, the action is brought directly against the criminal defendant, and is, therefore, an in personam action.

situations such as money laundering, gambling, savings and loan offenses, and a wide array of activity covered by Title 18.[196]

Any of these sections allow the government to seize property traceable to the illegal activity,[197] property used to "facilitate" or "facilitating" the illegal activity,[198] and property acquired with the proceeds of the illegal activity.[199] This would include the proceeds of the wrongdoers illegality. In addition, where the government seeks criminal forfeiture, the government may seek substitute assets.[200] Accordingly, the government may seize assets of the criminal defendant up to the value of the untraceable, ill-gained property.[201]

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[196] 18 U.S.C. §§ 981-82. These sections authorize forfeiture for violations of 18 U.S.C. §§ 1956, 1957, 1960, and others. §§ 981-82. Included as a violation of 18 U.S.C. § 956 is any of the activities listed in 18 U.S.C. § 1961. § 1956(c)(7). 18 U.S.C. § 1961 provides that "racketeering activity" is unlawful. § 1961(1). Specifically, 18 U.S.C. § 981(a)(1)(A) provides:

> Except as provided in paragraph (2), the following property is subject to forfeiture to the United States:
> (A) Any property, real or personal, involved in a transaction or attempted transaction in violation of section 5313(a) or 5324(a) of title 31, or of section 1956 or 1957 of this title, or any property traceable to such property . . . .

18 U.S.C. § 981(a)(1)(A).

[197] United States v. Daccarett, 6 F.3d 37, 57 (2d Cir. 1993). The court held that funds that were commingled, but traceable to illegal activity, were properly forfeited. *Daccarett*, 6 F.3d at 57.

[198] United States v. All Inventories of Bus. Known as Khalife Bros. Jewelry, 806 F. Supp. 648, 650 (E.D. Mich. 1992). The court held that 18 U.S.C. § 981(a)(1)(A) applies to property used to facilitate the crime of money laundering. *Khalife*, 806 F. Supp. at 650; *see also* United States v. All Monies In Account No. 90-3617-3, 754 F. Supp. 1467, 1473 (D. Haw. 1991) (finding "18 U.S.C. § 981(a)(1)(A) applies to all property that facilitates violations of §§ 1956 and 1957"). "Facilitating" has been said to occur when the property sought to be forfeited makes the underlying offense "less difficult." United States v. Schifferli, 895 F.2d 987, 990 (4th Cir. 1990).

[199] United States v. Eleven Vehicles, 836 F. Supp 1147, 1155 (E.D. Pa. 1993). If the government "can establish by a showing of probable cause that the properties are the proceeds of property used to facilitate the violation of 18 U.S.C. §§ 1956 or 1957," then the government is entitled to forfeiture. *Eleven Vehicles*, 836 F. Supp. at 1155.

[200] 18 U.S.C. § 982(b) (1996). This section incorporates the provisions of 21 U.S.C. § 853, providing for the substitution of assets of the defendant for the assets used in the offices. *Id.*

[201] 21 U.S.C. § 853(p) (1994). This section provides for the substitution of as-

At first glance, this would appear to be of little significance to participants of securitization because the income streams, once purchased by an independent SPV, do not belong to the originator. Furthermore, the benefits are not under the control of the SPV. However, this view fails to consider the relation back doctrine codified at 18 U.S.C. § 981(f)[202] and 18 U.S.C. § 982(b)(1).[203]

Under the relation back doctrine, notwithstanding the SPV's perfection of its purchase, the government may, nonethe-

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sets of the defendant if the property used in furtherance of the offense:
(1) cannot be located . . . ;
(2) has been transferred or sold to . . . a third party;
(3) has been placed beyond the jurisdiction of the court;
(4) has been substantially diminished in value; or
(5) has been commingled with other property . . . .
§ 853(p); *see also* 18 U.S.C. § 1963(m) (providing for substitution of assets in criminal racketeering context).

[202] 18 U.S.C. § 981(f) (1984). This section provides:

> All right, title, and interest in the property described in subsection (a) of this subsection shall vest in the United States upon commission of the act giving rise to forfeiture under this section.

Id.

[203] 18 U.S.C. § 982(b)(1) (1994). This section provides:

> Any property subject to forfeiture under this section, any seizure and disposition thereof, and any administrative or judicial proceeding in relation thereto, shall be governed
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> (A) in the case of a forfeiture of under subsection (a)(1) of this section, by subsections (c) and (e) through ¶ of section 413 of the Comprehensive Drug Abuse Prevention and Control Act of 1970 (21 U.S.C. 853); and
>
> (B) in the case of a forfeiture under subsection (a)(2) of this section, by subsection (b), (c), (e), and (g) through ¶ of section 413 of such Act.

Id. Therefore, this section incorporates provisions of 21 U.S.C. § 853. Among the provisions incorporated is 21 U.S.C. § 853(c) which provides:

> All right, title, and interest in property . . . vests in the United States upon the commission of the act giving rise to forfeiture under this section. Any such property that is subsequently transferred to a person other than the defendant may be the subject of a special verdict of forfeiture and thereafter shall be ordered forfeited to the United States . . . .

§ 853(c). Thus, 42 U.S.C. § 982, like 42 U.S.C. § 981, has codified the relation back doctrine.

less, prime the SPV's interest. The doctrine would divest the originator of the right to receive the income stream at the time the crime was committed. Presumably, this would be before the originator would sell the income stream to the SPV. Because the originator could convey to the SPV no more than what it owned, the SPV would take the income stream subject to the interest of the United States. Therefore, the income stream would be forfeited and investors would be left insecure.

However, in this situation, the SPV may have defenses to the forfeiture. In order to so prevail, the SPV would be required to satisfy at least two criteria. First, the SPV must show that it was a bona fide purchaser for value.[204] If the transaction properly is structured as a true sale, then the SPV probably could establish itself as a bona fide purchaser for value. Second, the SPV must also prove it neither knew nor should have known that the property was subject to forfeiture. This may be difficult where the SPV is created by the originator, since a strong argument could be made that the SPV had knowledge of the activity. The SPV with common directors as its originator's would know of the originator's activities. Therefore, the SPV would have knowledge sufficient to prevent the SPV from satisfying this exception.

Unless the SPV is able to satisfy this criteria, the income stream would be forfeited. If the SPV granted the investor's a security interest in the income stream, then, the investors may file a petition for remission through which they may reclaim

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[204] 18 U.S.C. § 981(a)(2) (1994). This section provides:

> No property shall be forfeited under this section to the extent of the interest of an owner or lienholder by reason of any act or omission established by that owner or lienholder to have been committed without the knowledge of that owner or lienholder.

Id. Similarly, 18 U.S.C. § 982(b)(1), incorporating 21 U.S.C. § 853, provides:

> Any such property that is subsequently transferred to a person other than the defendant may be the subject of a special verdict of forfeiture and thereafter shall be ordered forfeited to the United States, unless the transferee establishes in a hearing . . . that he is a bona fide purchaser for value of such property who at the time of purchase was reasonably without cause to believe that the property was subject to forfeiture under this section.

21 U.S.C. § 853(c) (1994).

their interests. Otherwise, the burden of repayment would fall on the credit enhancements provided.[205] The originator and the income stream could not be completely separated in this situation. Although the originator's financial condition would no longer affect the asset, the originator's activities would continue to affect the asset.

VII. CONCLUSION

Faulty separation, or dilution, may undermine the very purposes of asset securitization. However, the likelihood of its occurrence is minimal. Accordingly, the market will continue to expand to include new originators and new types of income streams. With this expansion, the risk associated with these transactions will increase. However, more importantly for those participating in such a transaction, with market expansion will likely come the financial anxiety over whether the structure of the transaction will allow the income stream to successfully separate from the originator. In most instances, failed separation, is a curable disease. For instance, ensuring separation is often as easy as filing a financial statement or executing a cutoff clauses. However, in other instances, complete separation may never occur. It is this risk which must be borne by the parties as a cost of participating in the transaction.

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[205] This result would also occur if the SPV had given the investors a security interest in the assets, since the SPV could only grant a security interest to the extent that it owned the property. Thus, because the innocent owner defense would not apply, then the security interest would, in effect, be in an interest inferior to that of the government's.

COMMENTS

THE EVOLVING LAW OF PERSONAL JURISDICTION FOR TRADEMARK INFRINGEMENT ON THE INTERNET*

Welcome to cyberspace![1] The age of the Internet is well upon us.[2] In a few short years, the Internet has infiltrated many aspects of both individual and business existence.[3] As

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* Winner, Earl T. Thomas Award for Excellence in Writing. This award is presented annually in recognition of the recipient's contribution to the art and the science of the law through authorship of the outstanding comment selected for publication by the *Mississippi Law Journal*. Presented by Alston, Rutherford, Tardy and Van Slyke Law Firm, Jackson, Mississippi.

[1] Intermatic Inc. v. Toeppen, 947 F. Supp. 1227, 1229 (N.D. Ill. 1996). The term "cyberspace" was first coined in 1984 in William Gibson's novel Neuromancer. Philip Elmer-DeWitt, *Welcome to Cyberspace: What is it? Where is it? And How Do We Get There?*, TIME, Mar. 22, 1995, at 4. In 1989, online users adopted the term to describe the global interconnection of Internet users. *Id.* "[Cyberspace] is, like Plato's plane of ideal forms, a metaphorical space, a virtual reality." *Id.*

[2] The Internet was initially created by the United States Department of Defense in the 1960's as a communications network which could withstand nuclear attack. Patrick F. McGowan, *The Internet and Intellectual Property Issues*, 455 Practicing Law Institute, PATENTS, COPYRIGHTS, TRADEMARKS, AND LITERARY PROPERTY COURSE HANDBOOK SERIES 303, 312 (1996). The military's computers were interconnected in such a way that loss of some of the computers would fail to disable the entire network. *Id.* Subsequently, other factions of the U.S. government and institutions of the education began to use the network. *Id.*

[3] Today, use of the Internet is worldwide, with the number of users expected

with any "new technology," the Internet has created the possibility of new problems for the legal community. Because the Internet is unconfined by any geographical boundaries, personal jurisdiction on the Internet poses a very real question anywhere in the country. This comment will analyze one aspect of this issue, focusing on the question of where personal jurisdiction is proper when a resident of one state in the United States uses the Internet to infringe the trademark of a resident of another state, regardless of whether that infringement is intentional or inadvertent. This comment provides a basic overview of trademark law and personal jurisdiction, then summarizes the few cases that have dealt with this issue, and concludes with an analysis of the current law of personal jurisdiction when an alleged trademark infringement occurs on the Internet.

A General Overview of Trademark Law

Trademarks provide the means through which consumers can identify the source of goods or services in the marketplace, while at the same time protecting the good will that a business has created.[4] Although trademark law originated in the

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to reach 27 million this year and 52 million by the year 2000. Carmen Fleetwood, *Software Firms Launching Products That Let Parents Screen the Internet*, Wall St. J., Nov. 20, 1995, at B5d; Mary Kathleen Flynn, *A Tiny Winery's Giant Reach*, U.S. News & World Rep., Oct. 30, 1995, at 84. Furthermore, experts predict the Internet will sustain large growth in such areas as "electronic banking, consumer products, computer software, electronic advertising, and many financial investment transactions." David Bender, *Emerging Personal Jurisdictional Issues on the Internet*, at 7, 18 (PLI Patents, Copyrights, Trademarks, and Literary Property Course Handbook Series No. 453, 1996) (citing *Surf's Up for New-Wave Bankers*, The Economist, Oct. 7, 1995, at 62; *Will Your Next Computer Be a Tin Can and a Wire?* (Sun Microsystems Java Software and the Internet), The Economist, Oct. 14, 1995, at 75; Joan Rigdon, *Hip Advertisers Bypass Madison Avenue When They Need Cutting-Edge Web Sites*, Wall St. J., Feb. 28, 1996, at B1; Jack Egan & Kenan Pollack, *Cashing in on the Internet: Building the Web is Good for Business*, U.S. News & World Rep., Nov. 13, 1995, at 81).

[4] S. Rep. No. 1333, 79th Cong., 2d Sess. (194610, reprinted in 1946 U.S. Code Cong. Serv. 1274, 1274; *see* United States v. Hon, 904 F.2d 803, 806 (2d Cir. 1990) (stating trademark law protects business investment in quality and reputation).

common law of unfair competition, the Lanham Act provides concurrent federal protection for trademarks used in interstate and foreign commerce.[5] The Lanham Act provides trademark protection for "any word, name, symbol, or device, or any combination thereof used . . . [or intended to be used] to identify and distinguish his or her goods . . . and to indicate the source of those goods."[6] To receive protection, a trademark must re-

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[5] 15 U.S.C. § 1051(a). Unlike patents and copyrights, trademarks are not protected by the Constitution. Instead, Congress used its Commerce power to enact the Lanham Act which provides federal protection for registered trademarks pursuant to trademark law and unregistered trademarks pursuant to the law of unfair competition. *Id.* §§ 1051(a), 1125(a). Although trade names cannot be registered, the Lanham Act protects trade names through unfair competition. 15 U.S.C. § 1125(a).

The Lanham Act provides extensive federal protection for registered trademarks by providing prima facie evidence of the mark's validity, an incontestable status for the mark, and constructive notice of the mark's ownership. *Id.* §§ 1057(b), 1065, 1072. For unregistered trademarks, the Lanham Act provides only as much protection as is afforded trademarks under common law, but enables parties to have access to the federal courts and offers the same substantial remedies which are available for the infringement of a registered mark. 15 U.S.C. § 1051(a). Prior to actual use, the Lanham Act affords some protection if an intent-to-use application is filed with the Patent and Trademark Office. 15 U.S.C. § 1051(b).

[6] 15 U.S.C. § 1127. Because of the Lanham Act's broad definition of "trademark," many untraditional expressions have received trademark protection, including "such things as a color, shape, smell, sound, or configuration." *United States Trademark Association Trademark Review Commission Report and Recommendations to UTSA President and Board of Directors*, 77 TMR 375, 421; *see, e.g.*, Qualitex Co. v. Jacobson Prods. Co., 115 S. Ct. 1300, 1304, 514 U.S. 159 (1995) (providing trademark protection for color and noting Coca-Cola's successful trademark of shape of bottle); Two Pesos, Inc. v. Taco Cabana, Inc, 505 U.S. 763, 776 (1992) (protecting trademark consisting of shapes and packaging constituting trade dress); Menendez v. Holt, 128 U.S. 514, 520 (1988) (finding single word constitutes protectable trademark); M. Kramer Mfg. Co. v. Andrews, 783 F.2d 421, 442 (4th Cir. 1986) (providing trademark protection for pictures); *In re* Clarke, 17 U.S.P.Q.2d 1238, 1239 (T.T.A.B. 1990) (holding smell can be protectable trademark); CITC Indus. v. Levi Strauss & Co., 216 U.S.P.Q. 512, 516 (T.T.A.B. 1982) (extending trademark protection to shoe soles); Kenneth Sutherlin Dueker, Note, *Trademark Law Lost in Cyberspace: Trademark Protection for Internet Addresses*, 9 HARV. J.L. & TECH. 483, 512 n.21 (1996) (noting successful trademark registration of NBC's three chimes and MGM's lion's growl and describing Harley Davidson's current application for registration of the sound of its engine). However, the Lanham Act specifically denies trademark protection to generic terms and their non-verbal equivalents; merely descriptive or misdescriptive marks; decep-

main inherently distinctive;[7] "functional" features of a product are afforded no trademark protection.[8] Trademark infringement occurs when the owner of the mark proves there is a likelihood that ordinary consumers will be confused as to the origin or affiliation of the defendant's goods or services.[9] Likelihood of confusion, and thus trademark infringement, is established using a balancing test consisting of several factors including, but not exclusively:

(1) the strength of the trademark;
(2) the degree of similarity between the two marks;
(3) the geographic and market proximity of the products;
(4) the likelihood the prior owner may one day enter the market of the subsequent owner;
(5) actual consumer confusion;

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tive, scandalous, or immoral marks; a flag, coat of arms, or other insignia; a name, portrait, or signature of a living individual without his consent; and a previously registered mark that is not abandoned and whose use would cause a likelihood of confusion. 15 U.S.C. § 1052 (1994).

[7] 15 U.S.C. § 1052(f). In order to qualify for protection, a trademark must be fanciful, arbitrary, or descriptive with a secondary meaning. Abercrombie & Fitch Co. v. Hunting World, Inc., 537 F.2d 4, 9 (2d Cir. 1976). If, at any time, a trademark loses its distinctiveness, the Lanham Act provides for cancellation of the trademark, and the mark is then thrust into the public domain. 15 U.S.C. § 1064(3) (1994). *See also*, 1 J. THOMAS MCCARTHY, MCCARTHY ON TRADEMARKS AND UNFAIR COMPETITION § 11.03[5] (3d ed. 1994) (noting no trademark protection for marks such as "cellophane," "escalator," and "aspirin" which were once fanciful, but became generic).

[8] Qualitex Co. v. Jacobson Prods. Co., 514 U.S. 159 (1995). "[A] product feature is functional if it is essential to the use or purpose of the article or if it affects the cost or quality of the article." Inwood Labs., Inc. v. Ives Labs., Inc., 456 U.S. 844, 850 n.10 (1982). *Compare Inwood Labs., Inc.*, 456 U.S. at 857-58 n.20 (1982) (upholding District Court's finding that color of drug capsules is functional); Qualitex Co. v. Jacobson Prods. Co., 514 U.S. 159, 131 L. Ed. 248, 255 (1995) (providing shape of light bulb as example of functional aspect of product); Kellogg Co. v. National Biscuit Co., 305 U.S. 111, 119-220 (1938) (explaining "pillow" shape of shredded wheat biscuit is functional); Deere & Co. v. Farmhand, Inc., 560 F. Supp. 85, 98 (S.D. Iowa 1982), *aff'd* 721 F.2d 253 (8th Cir. 1983) (discussing functionality of green color of farm machinery) *with In re* Owens-Corning Fiberglass Corp., 774 F.2d 1116, 1123 (Fed. Cir. 1985) (finding pink color of insulation is non-functional).

[9] McGraw-Edison Co. v. Walt Disney Prods., 787 F.2d 1163, 1167 (7th Cir. 1986). Actual confusion is not required. Estee Lauder, Inc. v. The Gap, Inc., 108 F.3d 1503, 1511 (2d Cir. 1997).

(6) the defendant's bad faith in adopting the mark;
(7) the quality of the defendant's product;
(8) the sophistication of the buyers.[10]

Trademark infringement occurs wherever a likelihood of confusion exists.[11] However, even if no likelihood of confusion can be established, injunctive relief is available in unfair competition for dilution of the distinctive qualities of both registered and unregistered trademarks or trade names.[12]

The simplistic commands which enable one Internet user to virtually copy and paste text, images, and sounds from one Web page to another make trademark infringement a very real concern of companies who advertise on the Internet.[13] Notably, such trademark infringement could pose a legal and monetary detriment to unwary individuals or small businesses who take advantage of the "cut and paste" concept in creating their own Web pages. As recent court decisions suggest, com-

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[10] Polaroid Corp. v. Polared Elecs. Corp., 287 F.2d 492, 495 (2d Cir. 1961), *cert. denied*, 368 U.S. 820 (1961). In applying the Likelihood of Confusion test, most jurisdictions give considerable weight to the buyer's state of mind. 1 MCCARTHY, *supra* note 7, § 23.01. The Fifth Circuit succinctly stated this deference to the buyer's subjective state of mind: "Good faith is not a defense to trademark infringement. . . . The reason for this is clear: if potential purchasers are confused, no amount of good faith can make them less so. Bad faith, however, may, without more, prove infringement." Fuji Photo Film Co. v. Shinohara Shoji Kabushiki Kaisha, 754 F.2d 591, 596 (5th Cir. 1985).

[11] 4 MCCARTHY, *supra* note 7, § 32.14[2] n.9.

[12] 215 U.S.C. §§ 1125(c), 1127 (1982 & Supp. I 1997). Dilution whittles away or dilutes the strong association consumers have between the mark or trade name and its owner. *Id.* § 1127. §43(a). Dilution occurs when one uses the same or highly similar mark for a dissimilar business or to identify dissimilar goods or services. Allied Maintenance Corp. v. Allied Mechanical Trades, Inc., 369 N.E.2d 1162, 1166 (N.Y.S. 1977). To assert a cause of action for federal dilution, the Lanham Act requires that the plaintiff's mark be famous. 15 U.S.C. § 1125(c)(1).

[13] Amy Harmon, *Web Wars: Companies Get Tough on Rogues, Studios and Fortune 500 Firms Target Unauthorized Internet Sites that Feature Their Products*, L.A. TIMES, Nov. 12, 1996, at A1. Recognizing that unauthorized information is being disseminated on the Internet about them, some companies are paying special attention to personal "home pages" or Web sites which either express opinions about the companies or incorporate the companies's trademarks. *Id.* "Brandishing trademark rights and asserting copyright claims, Fortune 500 companies including Time Warner, Kmart, Gateway 2000 and Intel Corp. are sending in the lawyers. Their quarry-usually individuals with scarce resources-typically agrees to shut down their sites or remove offending material." *Id.*

panies are willing to go to court to protect their trademarks from infringement on the Internet.[14]

PERSONAL JURISDICTION AND THE INTERNET

Although the Internet poses many new legal concerns, the basic rules of personal jurisdiction which govern traditional causes of action apply equally to causes of action involving online contacts.[15] Where federal jurisdiction is based on diversity of citizenship, jurisdiction over a non-resident defendant must not only meet the requirements of the long-arm statute of the forum state, but it must also satisfy the dictates of the Due Process Clause.[16]

Although the reach of a state's long-arm statute can extend to the limits of the Fourteenth Amendment, some states have chosen to specify in their long-arm statute those acts which will subject a non-resident to the state's jurisdiction. The most common acts by a non-resident which confer jurisdiction upon a state include either transacting business or committing a tortious act within that state.[17] Once the state's long-arm statute is satisfied, due process also must be examined and satisfied.[18] However, if a state exerts personal jurisdiction to the limits of the Due Process Clause, the test for personal jurisdiction is instead, a one-part analysis of due process only.[19]

When a defendant is not present in the forum, due pro-

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[14] *See* CompuServe, Inc., v. Patterson, 89 F.3d 1257 (6th Cir. 1996); Bensusan Restaurant Corp. v. King, 937 F. Supp. 295, (S.D.N.Y. 1996); Inset Sys., Inc. v. Instruction Set, Inc., 937 F. Supp. 161 (D. Conn. 1996); Maritz, Inc. v. CyberGold, Inc., 947 F. Supp. 1328 (E.D. Mo. 1996).

[15] 5 Mark Epstein, *Dealing with Jurisdictional Issues Presented By the Internet*, 2 No. 10 MULTIMEDIA STRATEGIST, 1, *3 (Aug. 1996). The most basic postulate regarding personal jurisdiction is that a court must have in personam jurisdiction over a defendant before the state can issue a judgment which personally binds that defendant. Pennoyer v. Neff, 95 U.S. 714, 732-33 (1878).

[16] *See* CHARLES ALAN WRIGHT & ARTHUR R. MILLER, FEDERAL PRACTICE AND PROCEDURE, *Civil* § 1075 n.50 (2d ed. 1987).

[17] 4 MCCARTHY, *supra* note 7, § 32.14.

[18] Jobe v. ATR Mktg., Inc., 87 F.3d 751, 753 (5th Cir. 1996).

[19] Helicopteros Nacionales de Colombia, S.A. v. Hall, 466 U.S. 408, 413 (1984).

cess requires that the defendant have "certain minimum contacts with [the forum] such that the maintenance of the suit does not offend traditional notions of fair play and substantial justice."[20] A state may exert general jurisdiction if the defendant's contacts with the forum are unrelated to the controversy, as long as the defendant's contacts with the forum are "substantial" or "continuous and systematic."[21] Specific jurisdiction exists if the "controversy is related to or 'arises out of' a defendant's contacts with the forum" and is determined by examining the "relationship among the defendant, the forum, and the litigation."[22] Although the test for specific jurisdiction is fact-specific, "essential in each case [is] that there be some act by which the defendant purposefully avails itself of the privilege of conducting activities within the forum state, thus invoking the benefits and protections of its laws."[23] Furthermore, the "defendant's conduct and connec-

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[20] International Shoe Co. v. Washington, 326 U.S. 310, 316 (1945) (quoting *Milliken v. Meyer*, 311 U.S. 457, 463 (1940)). Historically, in order for a state to assert personal jurisdiction over a non-resident defendant, the defendant must be physically present within the territorial jurisdiction of the court which seeks to assert personal jurisdiction. Pennoyer v. Neff, 95 U.S. 714, 733 (1878); *see generally* Burnham v. Superior Court, 495 U.S. 604, 619 (1990) (holding transitory presence of non-resident in forum state is sufficient for assertion of personal jurisdiction). However, as the availability of alternative forms of notice increased, the United States Supreme Court widened the acceptable bases for personal jurisdiction, holding that the Due Process Clause of the Fourteenth Amendment is satisfied if the defendant merely has sufficient minimum contacts with the forum state. *International Shoe*, 326 U.S. at 316. "Fair play and substantial justice" may be determined by evaluating "the burden on the defendant," "the forum State's interest in adjudicating the dispute," "the plaintiff's interest in obtaining convenient and effective relief," "the interstate judicial system's interest in obtaining the most efficient resolution of controversies," and the "shared interest of the States in furthering fundamental substantive social policies." World-Wide Volkswagen Corp. v. Woodson, 444 U.S. 286, 292 (1980).

[21] *Helicopteros Nacionales de Columbia, S.A.*, 466 U.S. at 414-16.

[22] Shaffer v. Heitner, 433 U.S. 186, 204 (1977).

[23] Hanson v. Denckla, 357 U.S. 235, 253 (1958). The forum state may exercise specific jurisdiction if the non-resident defendant purposely directs his activities at the forum and injury arises from or relates to this activity. Burger King Corp. v. Rudzewicz, 471 U.S. 462, 472, 475 (1985). Minimum contacts were established in *Burger King* where the court held that a Michigan franchisee was subject to suit in Florida for trademark infringement by a Florida franchisor because there existed a "substantial and continuing relationship" between the parties. *Id.* at 487. In

tion with the forum State [must be] such that he should reasonably anticipate being haled into court there" should controversies develop.[24] However, merely placing a product into the stream of commerce is insufficient to establish minimum contacts with the forum state in which the product surfaces.[25]

RECENT COURT DECISIONS INVOLVING PERSONAL JURISDICTION IN ACTIONS INVOLVING ALLEGATIONS OF TRADEMARK INFRINGEMENT ON THE INTERNET

Recently, the issue of personal jurisdiction on the Internet reached the federal courts. Unfortunately, those courts presented with this question reached differing conclusions in cases involving somewhat similar facts. Consequently, the state of jurisdictional law on the Internet still remains uncertain.

In *Inset Systems, Inc. v. Instruction Set, Inc.*, the United States District Court of Connecticut found that Connecticut could exercise personal jurisdiction over a Massachusetts

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determining minimum contacts, the Court evaluated the parties' "prior negotiations and contemplated future consequences, along with the terms of the contract and the parties' actual course of dealing. . . . " *Id.* at 479. Furthermore, the Supreme Court ruled in *Keeton v. Hustler Magazine, Inc.* that where a New Yorker sued an Ohio magazine for libel in New Hampshire, New Hampshire could assert personal jurisdiction over the magazine based on the substantial monthly sales of the magazine in New Hampshire. Keeton v. Hustler Magazine, Inc., 465 U.S. 770, 780-81 (1984). The Court noted that injury from a tort of libel occurs "wherever the offending material is circulated . . . even in a State in which [the injured] has hitherto been anonymous." *Hustler*, 465 U.S. at 777. Referencing the "single publication rule," the Court noted that the magazine could be liable for nationwide damages where the magazine was "aimed at a nationwide audience." *Id.* at 781. Similar to libel, trademark infringement occurs not only where the infringing mark originates, but also in every location where a customer is likely to be confused as to the origin of the goods or services. 4 MCCARTHY, *supra* note 7, § 32.14[1] n.9.

[24] *World-Wide Volkswagen*, 444 U.S. at 297. The quantity of contacts is insignificant, and the ability to foresee that the product will eventually wind up in the forum state is not dispositive. *Id.* at 297.

[25] Asahi Metal Indus. Co. v. Superior Court, 480 U.S. 102, 112 (1987) (plurality opinion). *See* Burger King Corp. v. Rudzewicz, 471 U.S. 462, 475 (1985) (citations omitted) (explaining minimum contacts do not exist where relationship is "random," "fortuitous," or "attenuated").

corporation that allegedly infringed the trademark of a Connecticut corporation when it used the Connecticut corporation's name as its Internet address and as its 1-800-U-INSET telephone number.[26] Inset Systems owned the rights to the federally registered trademark "INSET," whereas Instruction Set owned the Internet address "INSET.COM" and used the Internet address and toll free telephone number to advertise its goods and services.[27] The court found that, because of the repetitive accessibility of advertising on the Internet, the Connecticut long-arm statute permitted personal jurisdiction over Instruction Set.[28] Instruction Set claimed it

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[26] Inset Sys., Inc. v. Instruction Set, Inc., 937 F. Supp. 161, 162-63 (D. Conn. 1996). Both corporations served a global market, Connecticut-based Inset Systems developed and distributed computer software, whereas Massachusetts-based Instruction Set provided computer technology and support. *Inset Sys.*, 937 F. Supp. at 162. However, Instruction Set did not regularly transact business in Connecticut. *Id.* at 162-63.

[27] *Inset Sys.*, 937 F. Supp. at 163. Trademark infringement may result because

> [i]f a company uses a domain which is identical to the name or trademark of a company, an Internet user may inadvertently access an unintended company. Thereafter, the Internet user may not realize that the advertisement is actually from an unintended company, or the Internet user may erroneously assume that the source of information is the intended company. As a result, confusion in the marketplace could develop.

Id.

[28] *Id.* at 164. Connecticut's long-arm statute allows personal jurisdiction over foreign corporations that transact business in Connecticut if the cause of action arises "out of any business solicited in [Connecticut] by mail or otherwise if the corporation has repeatedly so solicited business, whether the orders or offers relating thereto were accepted within or without the state." *Id.* at 163 n.2 (quoting C.G.S. § 33-411(c)). Personal jurisdiction over Instruction Set was appropriate because Instruction Set "continuously advertised over the Internet, [including] at least 10,000 access sites in Connecticut." *Id.* at 164. The court distinguished the repetitive access inherent in Internet advertising from the limited reach and easy disposal of traditional "hard-copy advertisements." *Id.* *See also* Whelen Eng'g Co., Inc. v. Tomar Elecs., Inc., 672 F. Supp. 659, 667 (D. Conn. 1987) (holding personal jurisdiction was appropriate where defendant advertised in excess of one year in thirty publications which circulated in Connecticut, delivered thirty allegedly infringing publications in Connecticut, and sold two allegedly infringing products to residents of Connecticut); McFaddin v. National Executive Search, Inc., 354 F. Supp. 1166, 1169 (D. Conn. 1973) (finding Connecticut's long-arm statute requirement of repeated solicitations satisfied where, over six month period, six

lacked sufficient "minimum contacts" with Connecticut to satisfy due process, but the court concluded due process was not violated because Instruction Set could reasonably anticipate litigation in Connecticut since Instruction Set directed its advertisements to all Internet users, including those in Connecticut, on a continuous basis.[29] Furthermore, the court held adjudicating the suit in Connecticut was fair because the distance between the two states was minimal, Instruction Set retained counsel within the state of Connecticut, Connecticut had an interest in the matter, and resolution of the action in Connecticut was efficient.[30]

In a "novel question of first impression," the Sixth Circuit ruled in *CompuServe, Inc. v. Patterson* that Ohio could exercise personal jurisdiction over a Texas businessman whose only contact with Ohio was via the Internet.[31] Patterson "subscribed to CompuServe" and entered into an on-line contract with CompuServe to become a shareware provider.[32] After numerous successful dealings between the two parties, CompuServe began marketing software similar to one of

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ads were placed in newspaper that circulated within Connecticut).

[29] *Inset Sys.*, 937 F. Supp. at 164-65. In deciding that Instruction Set "purposely availed itself of the privilege of doing business within Connecticut, the court pointed out that by placing an advertisement on the Internet and providing a toll-free number, the advertiser directs the advertisement to all locations where the advertisement is received. *Id.* at 165. Internet advertisements differ from those of television and radio because Internet advertisements are continuously accessible by any Internet user, whereas television and radio advertisements are intermittently broadcasted and reach a limited number of people. *Id.*

[30] *Id.* at 165. Personal jurisdiction must not only be reasonably anticipated, but it must also comport with the requirement of "fair play and substantial justice." *Burger King Corp.*, 471 U.S. at 477-78.

[31] CompuServe, Inc., v. Patterson, 89 F.3d 1257, 1268 (6th Cir. 1996).

[32] *CompuServe*, 89 F.3d at 1260. Subscribers, such as Patterson, forwarded shareware software to CompuServe, which was based in Ohio, and CompuServe would then advertise the shareware software on its system. *Id.* at 1260, 1261. Other subscribers could then download the shareware software and voluntarily "pay the creator's suggested licensing fee . . . directly to CompuServe," who retained a 15% fee and forwarded the remaining balance to the creator of the shareware software. *Id.* at 1260. From his computer in Texas, Patterson contracted on-line with CompuServe to become a shareware provider. *Id.* at 1260-61. The on-line contract specified that Ohio law governed the transaction. *Id.* at 1260.

Patterson's shareware files.[33] Using electronic mail and the traditional postal service, Patterson contacted CompuServe, claiming CompuServe was infringing Patterson's unregistered trademark in the software and demanding a settlement to which CompuServe responded by filing a declaratory motion in federal court in Ohio.[34] The Sixth Circuit based its decision to grant Ohio personal jurisdiction on the court's evaluation of three requisite criteria: whether the defendant purposefully availed himself of Ohio's privileges; whether the cause of action arose from the defendant's activities within Ohio; and whether the exercise of personal jurisdiction was reasonable.[35] The court found the "purposeful availment" requirement satisfied because the defendant conducted business in Ohio when the defendant contracted with CompuServe to receive, advertise, and sell his software.[36] In addition, the

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[33] *Id.* at 1261. Over the course of four years, Patterson electronically transmitted 32 programs to CompuServe for inclusion in CompuServe's shareware program. *Id.* Although CompuServe provided global access via the Internet, Patterson "sold less than $650 worth of his software to only 12 Ohio residents via CompuServe." *Id.*

[34] *Id.* CompuServe sought to establish specific personal jurisdiction in Ohio over Patterson since Patterson transmitted software to Ohio for CompuServe to market on its network. *Id.* at 1263. Ohio's long-arm statute permits Ohio to exercise personal jurisdiction over a nonresident where a claim arises from business transacted in Ohio by the nonresident and enforces its jurisdiction to the extent that Due Process permits. *Id.* at 1262 (citing OHIO REV. CODE ANN. § 2307.382(A) (Anderson 1995)). Patterson requested a dismissal of CompuServe's declaratory motion, claiming Ohio lacked personal jurisdiction over him. *Id.* at 1261. The district court dismissed CompuServe's request for declaratory judgment, finding Patterson's contacts with Ohio "too tenuous to support the exercise of personal jurisdiction." *CompuServe*, 89 F.3d at 1259-60. Because the district court conducted no evidentiary hearing, the appellate court viewed "the pleadings and affidavits in a light most favorable" to the party attempting to assert the state's personal jurisdiction, allowing CompuServe to defeat Patterson's motion to dismiss for lack of personal jurisdiction by "mak[ing] a prima facie showing of jurisdiction." *Id.* at 1262. The Court of Appeals for the Sixth Circuit reversed and remanded. *Id.* at 1260.

[35] *Id.* at 1263 (quoting Reynolds v. International Amateur Athletic Fed'n, 23 F.3d 1110, 1116 (6th Cir. 1994).

[36] *Id.* at 1264. The court stated that "Patterson's relationship with CompuServe as a software provider and marketer . . . is crucial to this case . . . . CompuServe, in effect, acted as Patterson's distributor, albeit electronically and not physically." *Id.* at 1264-65. In determining the extent of the parties' relation-

defendant "'originated and maintained' contacts with Ohio" when he used the postal service and electronic mail to threaten litigation and offer settlement.[37] Furthermore, Patterson's contacts with CompuServe regarding trademark infringement "were contacts with Ohio" which led to CompuServe filing the declaratory motion at issue in the case.[38] Patterson's cause of action for trademark infringement originated in Ohio because Patterson's common law trademark was arguably created and allegedly infringed, at least in part, in Ohio.[39] Finally, the court found Ohio could reasonably assert personal jurisdiction over Patterson because "[s]omeone like Patterson who employs a computer network service like CompuServe to market a

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ship, the court considered that Patterson (1) subscribed to CompuServe, (2) contracted with CompuServe to provide shareware, (3) repeatedly uploaded his shareware software to Compuserve's system, (4) advertised his shareware software on the CompuServe system, (5) communicated with CompuServe concerning the potential litigation through both electronic and traditional mail, and (6) posted an outline of his case on one of CompuServe's' electronic bulletin boards. *Id.* at 1264, 1266.

[37] *CompuServe*, 89 F.3d at 1263. The court noted that personal jurisdiction may be appropriate even though the defendant has had no physical contact with Ohio. *Id.* at 1264. *See, e.g.*, Burger King Corp. v. Rudzewicz, 471 U.S. 462, 476 (1985) (requiring actions of defendant be "purposefully directed" at forum when physical contacts are lacking); Southern Mach. Co. v. Mohasco Indus., 401 F.2d 374, 382 (6th Cir. 1968) (finding personal jurisdiction where defendant's only contact with forum was through mailed solicitations); WSAZ, Inc. v. Lyons, 254 F.2d 242, 248 (6th Cir. 1958) (transmitting radio broadcasts into forum state sufficient to allow assertion of personal jurisdiction); Buckley v. New York Post Corp., 373 F.2d 175, 184 (2d Cir. 1967) (holding personal jurisdiction appropriate where newspapers and magazines are sent to forum to be sold by independent contractor); *but see* Hertz Sys., Inc. v. Hervis Corp., 549 F. Supp. 796, 797-98 (S.D.N.Y. (1982); (ruling that personal jurisdiction does not exist where newspapers inadvertently entered forum on subway).

[38] *CompuServe*, 89 F.3d at 1267. *See* American Greetings Corp. v. Cohn, 839 F.2d 1164, 1170 (6th Cir. 1988) (finding purposeful availment where California shareholder telephoned and mailed litigation threats and offers of settlement to Ohio corporation because shareholder "originated and maintained the required contacts with Ohio").

[39] *CompuServe*, 89 F.3d at 1267. Common law trademarks exist only after actual use of the trademark. *In re* Trade-Mark Cases, 100 U.S. 82, 94 (1879). Infringement of a common law trademark occurs anywhere a defendant attempts to pass off his product or service as that of the trademark owner. Vanity Fair Mills, Inc. v. T. Eaton Co., 234 F.2d 633, 639 (2d Cir. 1956).

product can reasonably expect disputes with that service to yield lawsuits in the service's home state."[40] However, the court specifically limited its decision to the factual situation at hand.[41]

In *Maritz, Inc. v. CyberGold, Inc.*, the Unites States District Court for the Eastern District of Missouri provided significant analysis regarding the issue of whether maintaining a Web site, without additional contacts with the forum, "amounts to promotional activities or active solicitations such as to provide the minimum contacts necessary for exercising personal jurisdiction over a non-resident corporation" in an action involving allegations of trademark infringement.[42] CyberGold was a California corporation whose only contact with Missouri was through its California-based Web cite where CyberGold explained that it would soon provide an Internet mailing list where any Internet user could sign up to

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[40] *CompuServe*, 89 F.3d at 1268. In finding Ohio's personal jurisdiction "comport[s] with 'traditional notions of fair play and substantial justice,'" the court considered several factors. *Id.* at 1268 (quoting Asahi Metal Indus. Co. v. Superior Court, 480 U.S. 102, 113 (1987) (plurality opinion)). First, Patterson was not overburdened because Patterson electronically contracted with CompuServe in Ohio, agreeing that Ohio law would control any resulting disputes. *Id.* at 1260-61, 1268. Second, Ohio had a "strong interest in resolving a dispute involving an Ohio company, which [would] involve the Ohio law on common law trademarks and trade names." *Id.* at 1268. Third, Patterson's claim could result in high monetary losses for CompuServe. *Id.* Fourth, the case could affect CompuServe's "relationships with other 'shareware' providers . . . who also directed their activities toward Ohio-based CompuServe." *Id.*

[41] *Id.* at 1268. Notably, the court refused to extend its decision regarding personal jurisdiction to other Internet controversies:

> We need not and do not hold that Patterson would be subject to suit in any state where his software is purchased or used; that is not the case before us. We also do not have before us an attempt by another party from a third state to sue Patterson in Ohio for, say, a "computer virus" caused by his software, and thus we need not address whether personal jurisdiction could be found on those facts. Finally, we need not and do not hold that CompuServe may, as the district court posited, sue any regular subscriber on its service for nonpayment in Ohio, even if the subscriber is a native Alaskan who has never left home. Each of those cases may well arise someday, but they are not before us now.

Id. at 1268 (citations omitted).

[42] Maritz, Inc. v. CyberGold, Inc., 947 F. Supp. 1328, 1332 (E.D. Mo 1996).

receive free electronic mail from advertisers who would compensate CyberGold for the service.[43] Maritz, a Missouri corporation claimed that CyberGold infringed its common-law trademark and was subject to Missouri's personal jurisdiction because CyberGold, through its Web cite, transacted business and committed a tortious act within Missouri.[44] CyberGold insisted that maintaining a passive Web site in California was insufficient contact with Missouri so as to allow Missouri to exercise personal jurisdiction over CyberGold.[45] The court disagreed with CyberGold, finding personal jurisdiction appropriate pursuant to the tortious act prong of Missouri's long-arm statute.[46] The court examined several factors, particularly the quality, quantity, and nature of CyberGold's contacts with Missouri, in determining that Missouri's exercise of personal jurisdiction over CyberGold comported with the dictates

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[43] *CyberGold*, 947 F. Supp. at 1330. CyberGold would also provide incentives for Internet users who read the advertisements forwarded to them from advertisers who used the CyberGold service. *Id.*

[44] *Id.* at 1330-31. Maritz had a common law trademark in GOLDMAIL and provided a similar service. *Id.* at 1339. Maritz claimed that the Web site advertised CyberGold's service to Internet users in Missouri and solicited advertisers from Missouri. *Id.* at 1330. CyberGold's Web site was accessed 131 times from within Missouri, excluding the number of times that Maritz's company accessed the site. *Id. See* Danforth v. Reader's Digest Ass'n, 527 S.W.2d 355, 356-57 n.2, 358 (Mo. 1975) (en banc) (finding personal jurisdiction where defendant twice mailed thousands of solicitations for magazine subscriptions into Missouri).

[45] *CyberGold*, 947 F. Supp. at 1333. The court dismissed CyberGold's characterization of its Web site as passive, because CyberGold's intent in maintaining the Web site was "to reach all [I]nternet users, regardless of geographic location" in order to create a mailing list for its advertisers. *Id.*

[46] *Id.* at 1331. Missouri's long-arm statute allows the state to exercise personal jurisdiction to the limits of due process for business transacted or torts committed in the state. *Id.* at 1330-31 (citing MO. REV. STAT. § 506.500). The court recognized that trademark infringement is a tort cause of action and proceeded to analyze the tort prong of Missouri's long-arm statute, disregarding the transacting business prong. *Id.* at 1331. However, the court pointed out that where the impact of tortious activity in the form of economic damages is the only contact with Missouri, personal jurisdiction violates due process. *Id.* at 1331-32. *See* May Dep't Stores Co. v. Wilansky, 900 F. Supp. 1154, 1161 (E.D. Mo. 1995) (finding exercise of personal jurisdiction requires more contact with forum than merely resultant damages); Peabody Holding Co., v. Costain Group PLC, 808 F. Supp. 1425, 1437 (E.D. Mo. 1992) (deciding that where only contact with forum was economic damages, personal jurisdiction violates Due Process Clause).

of the Due Process Clause.[47]

Soon afterwards, the United States District Court for the Southern District of New York decided *Bensusan Restaurant Corp. v. King*, finding that New York lacked personal jurisdiction over a Missouri defendant who allegedly infringed the federally registered trademark of a New York jazz club where the defendant merely posted the New Yorker's trademark at the defendant's Web site on the Internet.[48] King's site was

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[47] *CyberGold*, 947 F. Supp. at 1332-33. The court's test for minimum contacts sufficient for due process examines five factors:

(1) the nature and quality of the contacts with the forum state;
(2) the quantity of those contacts;
(3) the relation of the cause of action to the contacts;
(4) the interest of the forum state in providing a forum for its residents;
(5) the convenience of the parties.

Id. at 1332 (citing Bell Paper Box, Inc. v. U.S. Kids, Inc., 22 F.3d 816, 819 (8th Cir. 1994)). In examining the quality of the contacts, the court distinguished Internet communications from those of the telephone or traditional mail. *Id.* at 1332-33. Telephone communication requires additional media such as telephone books, television, magazines, or newspapers to advertise the telephone number. *Id.* at 1332. Telephone communication is also a slower and "more limited means of communication" than that of the Internet which only requires posting the information at a Web site to be rapidly and easily accessible from anywhere in the world. *Id.* at 1332-33. Similarly, communication through traditional mail differs from that of the Internet, because with traditional mail, specific areas can be targeted for solicitation, whereas with the Internet, information is provided "automatically and indiscriminately" to anyone who merely accesses the Web site using a topical search. *CyberGold*, 947 F. Supp. at 1333. Thus, the court concluded that because CyberGold "consciously decided to transmit advertising information to all [I]nternet users," the quality and nature of Cyborg's contacts favored Missouri's exercise of personal jurisdiction. *Id.* The court also found that the quantity of on-line contacts between CyberGold and Missouri residents supported a finding of personal jurisdiction. *Id.* As to the relation of Moritz's claim of trademark infringement to CyberGold's contacts with Missouri, the court found "CyberGold, through its [I]nternet activities, purposefully availed itself of the privilege of doing business with [Missouri] such that it could reasonably anticipate the possibility of being haled into court [there]." *Id.* at 1334. The court also found Missouri's interest in adjudicating the case sufficient, and CyberGold's burden of adjudicating in Missouri insufficient, so as to permit Missouri to exercise personal jurisdiction over CyberGold. *Id.*

[48] Bensusan Restaurant Corp. v. King, 937 F. Supp. 295, 297 (S.D.N.Y. 1996). Bensusan operated a nationally-known jazz club in New York and owned the rights to "The Blue Note" trademark. *Id.* King owned a small jazz club in Missouri with the same name. *Id.* Bensusan also had a Web site on the Internet

connected to the Internet through a Missouri computer server, was generally accessible to anyone on the Internet, and contained a logo similar to Bensusan's logo.[49] However, King's site only contained information about his Missouri club, including scheduled events and ticket information, as well as a disclaimer that distinguished King's Missouri club from Bensusan's New York club.[50] Bensusan filed a suit in New York, claiming trademark infringement, trademark dilution and unfair competition, each of which King moved to dismiss for lack of personal jurisdiction.[51] Bensusan claimed that New York could assert specific personal jurisdiction pursuant to New York's long-arm statute which allows personal jurisdiction over a non-domiciliary who: (1) commits a tortious act within the state,[52] or (2) commits tortious acts outside the

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through which he advertised his "Blue Note" club. *Id.* at 297.

[49] *Bensusan*, 937 F. Supp. at 297 (citations omitted).

[50] *Id.* at 297-98. King's Web site provided information about the Missouri "Blue Note," but conducted no business via the Internet. *Id.* at 297. King's Web site provided the names of ticket venues in Columbia, Missouri and a telephone number for charging tickets by phone. *Id.* However, club-goers were required to pick up their tickets at the club's box office in Missouri on the night of the show. *Id.*

King's Web page contained a disclaimer which stated: "The Blue Note's Cyberspot should not be confused with one of the world's finest jazz club[s] [the] Blue Note, located in the heart of New York's Greenwich Village. If you find yourself in the big apple give them a visit." *Bensusan*, 937 F. Supp. at 297-98. . Furthermore, King's Web site contained a hyperlink which allowed Web browsers to directly access Bensusan's Web site simply "by 'clicking' on the link." *Id.* at 298. King removed the last sentence of the disclaimer and the hyperlink when Bensusan filed his complaint in that case. *Id.*

[51] *Id.* at 298. Because no evidentiary hearing or discovery had been conducted, Bensusan needed only to make a prima facie showing that personal jurisdiction existed. *Id.* In addition, the court was required to view Bensusan's complaint and affidavits in a light most favorable to Bensusan's position. *Id.*

[52] *Id.* at 299 (quoting N.Y. CIV. PRAC. L. & R. § 302(a)(2) (McKinney 1996)). Trademark infringement occurs where a defendant passes off his product as that of the plaintiffs and a deceived customer purchases the defendant's product, believing he has purchased the plaintiff's product. *Id.* (citing Vanity Fair Mills, Inc. v. T. Eaton Co., 234 F.2d 633, 639 (2d Cir. 1956)). New York had already determined that simply offering to sell a single copy of an infringing product vests a court with personal jurisdiction, regardless of whether any sale actually results. *Id.* The court phrased the issue as "whether the creation of a Web cite, which exists either in Missouri or in Cyberspace — i.e., anywhere the Internet exists —

state "that cause injury in the state if the non-domiciliary 'expects or should reasonably expect the act to have consequences in the state and derives substantial revenue from interstate or international commerce.'"[53] Bensusan contended that because King knew that his Web site would be assessable in New York, King was obligated to restrict access of his site to specific geographic locations.[54] The court reasoned that providing information about ticket purchasing was not the equivalent of offering to sell the allegedly infringing product; therefore, King neither committed a tortious act in New York nor directed a tortious act toward New York.[55] Furthermore, the court determined that King could not expect his actions to have consequences in New York, reasoning that King relied almost exclusively upon patronage by local Missouri customers, King did not derive substantial revenue from interstate commerce, and Bensusan's indirect financial loss was not the equivalent of the statutory requirement of "significant economic injury."[56] Considering due process, the court specifically stated that "[c]reating a site, like placing a product into the

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with a telephone number to order the allegedly infringing product, is an offer to sell the product in New York." *Id.*

[53] *Id.* (quoting N.Y. CIV. PRAC. L. & R. § 302(a)(3)(ii) (McKinney 1996)).

[54] *Bensusan*, 937 F. Supp. at 300. The court concluded, however, "mere foreseeability of an in-state consequence and a failure to avert that consequence is not sufficient to establish personal jurisdiction." *Id.*

[55] *Id.* at 299. The court explained that because a New York resident had to access King's Web page to get ticket information, telephone the Missouri box office to purchase the tickets, and then actually travel to the Missouri club to pick up the tickets since King did not mail out tickets, any alleged infringement would occur in Missouri. *Id.* "The mere fact that a person can gain information on the allegedly infringing product is not the equivalent of a person advertising, promoting, selling or otherwise making an effort to target its product in New York." *Id.*

[56] *Id.* at 300. Foreseeability of consequences in the forum "requires that the defendant make 'a discernable effort . . . to serve, directly or indirectly, a market in the forum state.'" *Id.* at 300. Because King did not attempt to serve a New York market, the court reasoned that King did not foresee the consequences of his actions in New York. *Id.* Furthermore, the court stated that merely participating in interstate commerce by hiring bands of "national stature" was not the equivalent of deriving "substantial revenue from interstate commerce" which New York's long-arm statute requires for personal jurisdiction. *Id.*

stream of commerce, may be felt nationwide — or even worldwide — but, without more, it is not an act purposefully directed toward the forum state."[57]

Implications of Recent Court Decisions Concerning Personal Jurisdiction for Trademark Infringement on the Internet

Until New York's decision in *Bensusan*, the trend in the courts was to allow personal jurisdiction in forums where allegedly infringing trademarks could be accessed on the Internet instead of restricting personal jurisdiction to the state where the data was uploaded onto a network that provided access to the Internet or where a likelihood of confusion between the marks could be shown.[58] However, because the facts in *Inset Systems*, *CyberGold*, and *Bensusan* somewhat overlap, little guidance for Internet users may be derived by contrasting those cases. *CompuServe* is fairly easily distinguishable from *Bensusan*, *Inset Systems*, and *CyberGold* in that *CompuServe* involved numerous contacts with the forum via electronic and traditional mail and an actual contract with a corporation in the forum which then sold the software for the developer.[59] Personal jurisdiction may be more easily satisfied in that context because the facts of CompuServe involved more traditional contacts with the forum, which have been decided previously in the courts, such as contracting with and telephoning a resident in the forum.

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[57] *Id.* at 301. In determining the protection of due process, the court examined three factors: purposeful availment, anticipation of litigation in the forum, and continuous and systematic business conducted within the forum. *Id.* at 300-01 The court primarily focussed on the passivity of King's infringement and concluded by distinguishing the facts and resulting decision in *Bensusan* from those in CompuServe, Inc. v. Patterson, 89 F.3d 1257 (6th Cir. 1996). However, the court neglected to mention the decisions in either Inset Sys., Inc. v. Instruction Set, Inc., 937 F. Supp. 161 (D. Conn. 1996), or Maritz, Inc. v. CyberGold, Inc., 947 F. Supp. 1328 (E.D. Mo. 1996).

[58] *See, e.g.*, CompuServe, Inc. v. Patterson, 89 F.3d 1257 (6th Cir. 1996); Inset Sys., Inc. v. Instruction Set, Inc., 937 F. Supp. 161 (D. Conn. 1996); Maritz, Inc. v. CyberGold, Inc., 947 F. Supp. 1328 (E.D. Mo. 1996).

[59] *See supra* note 36 and accompanying text.

However, the remaining three cases reside far more in the gray zone of personal jurisdiction. Although *Inset Systems*, *CyberGold*, and *Bensusan* involved similar factual characteristics, *Bensusan* resulted in a differing legal conclusion. One distinction between the cases may be the determination of whether the defendants directed their activities at the forum,[60] considering the relative geographic reach of the defendants' actual businesses.[61] In *Inset Systems*, the defendant directed its advertising to all Internet users, including those in Connecticut.[62] In *CompuServe*, the defendant directed his shareware to the network in Ohio.[63] In *CyberGold*, the defendant directed its infringing solicitations to all Internet users within and without Missouri.[64] Furthermore, in *Inset Systems*, *CompuServe*, and *CyberGold*, each of the defendants served, or intended to serve, a national or international market.[65] Conversely, in *Bensusan*, the defendant owned a jazz club located in Missouri that could only be patronized by a customer's actual presence at the club's one physical location in Missouri.[66] However, this distinction may be somewhat arbitrary since, by placing the telephone number for ticket sales at the Web site, the defendant in *Bensusan* may have impliedly intended to reach potential customers outside of

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[60] *Compare* CompuServe v. Patterson, 89 F.3d 1257, (6th Cir. 1996) (allowing forum to exert personal jurisdiction); Inset Sys., Inc. v. Instruction Set, Inc., 937 F. Supp. 161 (D. Conn. 1996) (finding personal jurisdiction appropriate in forum where trademark owner resides); Maritz, Inc. v. CyberGold, Inc., 947 F. Supp. 1328, (E.D. Mo. 1996) (exercising personal jurisdiction over defendant) *with* Bensusan Restaurant Corp. v. King, 937 F. Supp. 295, (S.D.N.Y. Sept. 9. 1996) (holding personal jurisdiction over defendant violates due process).

[61] Epstein, *supra* note 15, at *5. Personal jurisdiction may be more appropriate outside the defendant's home forum if the defendant's business is of a type that permits him to conduct business outside of that forum. However, the converse may be true if the defendant's business is of a type that requires his customers to be physically present in the defendant's home forum in order for the defendant to be able to transact business.

[62] *See supra* note 29 and accompanying text.

[63] *See supra* notes 36-37 and accompanying text.

[64] *See supra* note 47 and accompanying text.

[65] *See supra* note 26, 33, 45 and accompanying text.

[66] *See supra* note 48, 49 and accompanying text.

Missouri that may then come to Missouri and patronize his jazz club.[67]

Another important differentiation among the cases may be the courts' determinations of those actions which constitute advertising. However, such a determination depends, to some extent, upon the individual state's long-arm statute and that court's interpretation of that statute.[68] The court in *Inset Systems* found Internet advertising existed and was directed at the forum where the defendant maintained a Web site address and a toll free telephone number, both of which contained the allegedly infringing trademark.[69] In *CyberGold*, the court found that where the defendant provided information about its upcoming service, but intended to eventually compose a mailing list and solicit advertisers, such actions constituted an advertisement directed at all forums so as to permit personal jurisdiction in the plaintiff's forum.[70] However, the court in *Bensusan* did not find personal jurisdiction, deeming the defendant's Web site an information site instead of an advertisement, even though the defendant's site arguably "advertised" the defendant's calendar of events and the telephone number for ticket sales.[71]

Although black letter law does not exist for determining whether a state may exercise personal jurisdiction over a defendant who uses the Internet to infringe the trademark of another, some factors tend to support such an exercise of personal jurisdiction.[72] A finding of personal jurisdiction may be

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[67] *See supra* note 50 and accompanying text.

[68] *See supra* note 29 and accompanying text.

[69] *See supra* note 45 and accompanying text.

[70] *See supra* note 50 and accompanying text.

[71] Epstein, *supra* note 15, at *5. Before the court's decision in Bensusan Restaurant Corp. v. King, 937 F. Supp. 295 (S.D.N.Y. 1996), these factors may have seemed a more solid basis upon which trademark holders could depend for a finding of personal jurisdiction. However, because *Bensusan* is the only case in which a court found personal jurisdiction outside of the defendant's home forum inappropriate in an action for trademark infringement on the Internet, these factors may still provide somewhat of a guide for trademark holders seeking to establish personal jurisdiction in a particular forum.

[72] *Id. See, e.g.*, CompuServe, Inc. v. Patterson, 89 F.3d 1257, 1264, (6th Cir. 1996) (finding defendant directed software to forum); Inset Sys., Inc. v. Instruction

more likely where the defendant targets his message to the particular forum.[73] Also, "[e]ngaging in some activity within the forum [that has been] traditionally handled via direct contact" may tip the scales in favor of personal jurisdiction.[74] Finally, if the defendant actually interacts with Internet users in the forum, a state may be more willing to find that personal jurisdiction over the defendant is appropriate.[75] However, these recent court decisions indicate that none of these factors are dispositive.

CONCLUSION

Considering that the Internet has virtually erased business and communication boundaries, Internet users in Mississippi may soon be faced with legal issues which seemed realistically remote before the Internet enabled individuals and businesses in Mississippi to connect easily and directly to others worldwide. Recognizing that businesses are willing to litigate to protect their trademarks on the Internet, attorneys and Internet users alike should be aware of the changing legal ramifications that accompany maintaining a Web site on the Internet.

In the near future, Mississippi attorneys could conceivably

Set, Inc., 937 F. Supp. 161, 165, (D. Conn. 1996) (deciding Internet advertisements were directed to all forums); Maritz, Inc. v. CyberGold, Inc., 947 F. Supp. 1328, 1334 (E.D. Mo. 1996) (holding Internet activities of defendant were directed at state attempting to exert personal jurisdiction); Playboy Enters., Inc. v. Chuckleberry Publ'g, Inc., 939 F. Supp. 1032, 1039 (finding infringing activities directed at United States where Italian defendant maintained English Web site and sold passwords to Internet users in United States).

[73] *Id. See, e.g.*, CompuServe, Inc. v. Patterson, 89 F.3d 1257, 1267 (6th Cir. 1996) (forwarding software to forum via computer network supported finding of personal jurisdiction); Plus Sys., Inc. v. New England Network, Inc., 804 F. Supp. 111, 118-19 (D. Colo. 1992) (transacting business between computers via a modem is equivalent to direct contact and sufficient for personal jurisdiction).

[74] *Id. See, e.g.*, CompuServe, Inc. v. Patterson, 89 F.3d 1257, 1267 (6th Cir. 1996) (holding on-line contracting supported forum's exercise of personal jurisdiction).

[75] *Id. See, e.g.*, CompuServe, Inc. v. Patterson, 89 F.3d 1257, 1267 (6th Cir. 1996) (finding personal jurisdiction in forum with which defendant communicated via electronic and traditional mail).

be faced will either filing or defending an action for trademark infringement which stems from a client's Internet contacts. Although this comment provides an overview of the contrasting court decisions regarding personal jurisdiction in the context of trademark infringement on the Internet, the law in this area is still developing. At the present time, probably the best legal guidance available on this subject is to be aware of the legal changes that are taking place and to realize that seemingly harmless words, images, or sounds that are unwittingly featured at Web sites may very well result in litigation in a distant state.

Lea Hall

OBSERVATION: EXCLUSIVE CONTRACTS AND THE STAFF PHYSICIAN

INTRODUCTION

Over the last decade, the health care industry has evolved in an attempt to better answer the needs of consumers while at the same time continuing to thrive economically. With increasing use of managed care, such as HMO's, PPO's, PHO's, MSO's, and other health provider organizations, the industry, as a whole, is undergoing significant changes. As hospitals strive to lower costs and continue reliable health care, many are turning to the use of exclusive provider agreements. Physicians, who are "left out in the cold,"[1] have no choice but to challenge these exclusive contracts and fight for hospital staff privileges.[2]

An exclusive contract between a hospital and a specific

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[1] June D. Zellers & Michael R. Poulin, *Termination of Hospital Medical Staff Privileges for Economic Reasons: An Appeal for Consistency*, 46 ME. L. REV. 67, 69 (1994). Generally, a physician is not guaranteed a right to practice in either a public or private hospital. *Id.* A hospital allows a physician to have access to its facilities by the granting of medical staff privileges. Sheree L. McCall, *A Hospital's Liability for Denying, Suspending and Granting Staff Privileges*, 32 BAYLOR L. REV. 175, 175 (1980). Thereafter, it is essential for a physician to maintain his staff privileges for a viable medical practice. *Id.* With the use of exclusive contracts, physicians find themselves unable to use the staff privileges that are so vital to their profession. Peter E. Borkon, Comment, *Exclusive Contracts: Are Constructively Terminated Incumbent Physicians Entitled to a Fair Hearing?*, 17 J. LEGAL MED. 143, 144 (1996).

[2] David A. Schaefer et al, *Exclusive Arrangements in Health Care: Moving Toward Freedom From the Antitrust Threat?*, 33 FED. B. NEWS & J. 327, 328 (1986). Typical litigation arises from such hospital action which includes denial, reduction, suspension, or termination of staff hospital privileges and/or contracting with an exclusive provider organization. *Id. See generally*, Bruce I. McDaniel, Annotation, *Validity and Construction of Contract Between Hospital and Physician Providing for Exclusive Medical Services*, 74 A.L.R. 3D 1268, 1270-72 (1976) (discussing various early challenges to exclusive contracts).

group of physicians binds the parties to buy or sell only from each other for their total requirements.[3] The bulk of exclusive agreements concern hospital-based physicians such as anesthesiologists, radiologists, and pathologists.[4] The use of such agreements by physicians in these and in other areas of practice has become more widespread with the increasing trend toward managed care.[5]

Proponents of exclusive health care arrangements point to the stability of maintaining a specific staff and the reduction of patient costs while maintaining a high level of service.[6] Also, by clearly delineating the hospital and the specific physician group, exclusive contracts prevent a hospital's liability for the negligence of its staff.[7] However, the downside to exclu-

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[3] Borkon, *supra* note 1, at 143-45. The typical exclusive contract provides that no other doctor will be allowed to practice in the area exclusively agreed, leaving the incumbent physician "constructively terminated." *Id.* at 144.

[4] William J. Lynk, *Restraint of Trade Through Hospital Exclusive Contracts: An Economic Appraisal of the Legal Theory*, 9 J. HEALTH POL., POL'Y & L., 269, 269-70 (1984). Typically, litigation concerning exclusive contracts covers hospital-based specialties. *Id.*

[5] Borkon, *supra* note 1, at 143. The use of exclusive contracts has increased with the present expansion of managed care. *Id.*

[6] Schaefer, *supra* note 2, at 327. Courts have acknowledged that exclusive contracts provide a number of benefits, such as:

> (1) greater control and standardization of procedures resulting in lower operating costs; (2) more efficient scheduling of facilities and support staff; (3) reduced machinery breakdowns and maintenance problems resulting from fewer equipment users; (4) improved monitoring assuring that medical quality standards are met; (5) better work routines and team work because physicians, nurses, and technicians, acquainted with each other, work together more often; (6) greater competence due to increased specialization with attendant development of skills through repetition of specialized procedures; (7) higher commitments made by the physicians to a smoother running institution; and (8) an enhanced reputation for excellence enabling the hospital to attract top flight physicians, thereby avoiding malpractice litigation.

Id. at 328.

[7] *Id.* at 327. *See* Broussard v. United States, 989 F.2d 171, 174-75 (5th Cir. 1993) (stating that amount of control over physician's performance is deciding factor for independent contractor); Lilly v. Fieldstone, M.D., 876 F.2d 857, 859 (10th Cir. 1989) (holding that physician was independent contractor and therefore government was not liable for his negligence).

sive contracts is, of course, the ousted or would-be physician who can not provide services or use the facilities at the hospital.[8] Excluded physicians have attacked exclusive contracts using, among others, theories of antitrust, due process, and breach of contract.[9]

This comment focuses on various arguments posited by incumbent physicians in challenging termination medical staff privileges by exclusive contracts. More specifically, discussion and case analysis will primarily concern due process and contractual issues, with an emphasis on the latter.[10] In the breach of contract analysis, Mississippi authority will be used, wherever possible, to support the discussion. Finally, this comment will provide practical suggestions that will hopefully benefit future creation of hospital employment contracts or bylaw construction.

DUE PROCESS CONSTRAINTS

An exclusive contract which effectively terminates a physician's hospital staff privileges should first be challenged under Constitutional due process grounds.[11] Due Process, as

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[8] Schaefer, supra note 1, at 327. Physicians who are not a party to the exclusive agreement are essentially precluded from practicing in a particular institution. *Id.*

[9] Carolyn Quinn, *Procedural Due Process Rights of Physicians Applying for Hospital Staff Privileges*, 17 Loy. U. Chi. L.J. 453, 455 n. 12(1986). Physicians have litigated under actions in tort, contract, and antitrust. *Id. See, e.g.*, Robinson v. Magovern, 521 F. Supp. 842 (W.D. Pa. 1982) (holding that exclusion from staff constitutes unreasonable restrain of trade); Ishak v. Fallston Gen. Hosp. & Nursing Center, 438 A.2d 1369 (Md. 1982) (involving claim that bylaws of hospital created contractual right to staff privileges); Nashville Memorial Hosp., Inc. V. Binkley, 534 S.W.2d 318 (Tenn. 1976) (hearing tort claim based on intentional interference with contractual relationship).

[10] This comment does not discuss the potential antitrust implications of exclusive contracts. However, since the Sherman Act only prohibits unreasonable restraints of trade, antitrust challenges to exclusive contracts have generally failed to produce significant results. Schaefer, *supra* note 1, at 328. *See* Jefferson Parish Hospital v. Hyde, 466 U.S. 2 (1984) (holding that exclusive contract between hospital and physician is not per se violation of section 1 of Sherman Antitrust Act).

[11] As a practical matter once governmental action is shown, a physician who has lost staff privileges can easily show that a due process hearing is in order

provided by the Fifth and Fourteenth Amendments to the United States Constitution, guarantees that individuals will be provided a fair hearing prior to any governmental deprivation of life, liberty, or property.[12] Of course, the central issue in a due process challenge is whether there has been some type of governmental action.[13]

Problems with Private Hospitals

In the context of hospital termination of staff privileges, courts have failed to provide clear guidelines for determining whether a hospital qualifies as a public entity and therefore establishing government action.[14] Publicly owned hospitals are certainly governmental actors with regard to due process concerns.[15] However, courts have generally held the due process obligations of private hospitals are different than those of

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before the privileges can be terminated, even for economic reasons.

[12] U.S. CONST. amend. V (stating in relevant part "No person shall be . . . deprived of life, liberty, or property, without due process of law . . . ."); U.S. CONST. amend. XIV, § 1 (stating in relevant part "No state shall . . . deprive any person of life, liberty, or property, without due process of law . . . .").

[13] Quinn, *supra* note 9, at 453. A physician alleging a due process violation has a formidable challenge in finding state action. *Id.* at 456 n.20. The United States Supreme Court has emphasized that the due process clause was designed to protect against wrongful governmental actions:

> Historically, this guarantee of due process has been applied to *deliberate* decisions of government officials to deprive a person of life, liberty, or property . . . . This history reflects the traditional and common sense notion that the Due Process Clause, like its forebear in the Magna Carta, was 'intended to secure the individual from the arbitrary exercise of the powers of government. *The touchstone of due process is protection of the individual against arbitrary action of government.*'

Daniels v. Williams, 474 U.S. 327, 330 (1986) (emphasis added). *See* Tunca v. Lutheran Gen. Hosp., 844 F.2d 411, 413 (7th Cir. 1988) (holding that denial of privileges is not state action because misconduct not directed by state); Briscoe v. Bock, 540 F.2d 392, 394-95 (8th Cir. 1976) (finding state action in public hospitals' administration).

[14] Borkon, *supra* note 1, at 152-53. Generally, courts have held public hospitals and private hospitals to different standards regarding due process concerns. *Id.*

[15] *See generally* Laje v. R.E. Thomason Gen. Hosp., 665 F.2d 724, 728 (5th Cir. 1982) (holding public hospital liable for due process violation).

public hospitals. In fact, unless the institution is considered to be some type of quasi-governmental actor,[16] a private hospital is free to adversely affect the physician's medical privileges regardless of a due process hearing.[17] Seemingly, all that is left for the physician is some type of state claim such as a breach of contract action, as discussed *infra*.

Existence of Property or Liberty Interest?[18]

Once government action is found, a due process challenge must include a liberty or property interest of sufficient magnitude to merit constitutional protection.[19] Staff privileges may be considered a property interest if, either the hospital grants the physician medical staff privileges accompanied by an understanding the privileges will not be terminated without an institutional procedure, or some property interest is created by statutory enactment, case law, or explicit understanding.[20] In

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[16] McCall, *supra* note 1 at 176. The quasi-public classification was created to solve the problem of the private actor. *Id.* Courts have used a three-part test to determine whether a sufficient nexus exists to consider a private hospital as a governmental actor. *Id.* at 178 (citing Barrett v. United Hosp., 376 F. Supp. 791 (S.D. N.Y. 1974)). The prongs are: "(1) a direct connection between the state and the failure to grant medical staff privileges at the hospital; (2) significant financial assistance to the hospital by the government; and (3) the hospital's performance of a public function." Peter E. Borkon, *supra* note 1, at 159. This quasi-public theory is followed in New Jersey, Hawaii, and California. *Id.* at 159 n. 194.

[17] *See* Ezpeleta v. Sisters of Mercy Health Corp., 800 F.2d 119, 122-23 (7th Cir. 1986) (holding that private hospital's decision to terminate staff privileges was not attributable to state); St. Mary's Hosp. v. Radiology Prof'l Corp., 421 S.E.2d 731 (Ga. App. 1992) (ruling that since hospital was private, no due process was due to physician).

[18] For an in-depth discussion of the courts' handling of the property and liberty interest issues, see Quinn, *supra* note 9, at 461-65.

[19] *See* Board of Regents v. Roth, 408 U.S. 564, 577-78 (1972)(developing test to determine if employee has sufficient material property interest in continued employment).

[20] Lowe v. Scott, 959 F.2d 323, 336-38 (1st Cir. 1992). A property interest in staff privileges can be created by the hospital's bylaws, applicable state statutes, or judicial decisions. *Lowe*, 959 F.2d at 338. In *Lowe*, however, the court did not find any evidence that the physician's staff privileges acted as a property interest. *Id.* at 339. *See* Orloff v. Cleland, 708 F.2d 372, 377 (9th Cir. 1983) (stating that property interests "are created by 'rules or understandings' from independent

determining if a liberty interest exists, most courts adhere to the "stigma-plus" established in the post-*Roth* cases.[21]

Once a governmental action and a sufficient property or liberty interest are found, the next question concerns the degree of procedure that is due.[22] In measuring the sufficiency of procedural due process, courts consider the importance of the individual interest at stake, the risk of error considered with the value of additional procedures, and finally, the government's interest in avoiding the burdens of an expanded process.[23] Because of the subjective nature of procedural due process, such process can range from simple notice to the traditional trial type of hearing.[24]

In considering private hospitals, courts have correctly held that because private hospitals are not governmental actors, due process need not be mandated regardless of the property or liberty interest involved.[25] In fact, unless the court considers the hospital as some type of "quasi-public" institution or establishes a sufficient nexus between the state and the hospital, physicians are relegated to state action theories when

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sources, such as statutes, regulations, and ordinances, or express or implied contracts."); Gillies v. Utah County, 765 F. Supp. 692, 694 (D. Utah 1991) ("A property interest may be created by state statute, administrative rule, or explicit understanding.").

[21] For a discussion of various cases applying liberty interest to termination of staff privileges, see Quinn, *supra* note 9, at 463-65.

[22] *See* Morrissey v. Brewer, 408 U.S. 471, 481 (1972) (stating "[D]ue process is flexible and calls for such procedural protections as the particular situation demands").

[23] Mathews v. Eldridge, 424 U.S. 319, 335 (1976). The Court applied these factors to determine if Mr. Eldridge was afforded proper procedures for the termination of his benefits. *Id.* at 321.

[24] Quinn, *supra* note 9, at 466. Rarely are full trial-type hearings required, but courts usually mandate a "generous range" of protection prior to termination. *Id.* Normally, a medical staff peer review system provides adequate scrutiny to the decision. *Id.* at 467.

[25] *See, e.g.*, Pariser v. Christian Health Care Sys., 816 F.2d 1248, 1252 (8th Cir. 1987) (suspending privileges by private hospital not state action because no nexus between government and conduct); Sarin v. Samaritan Health Ctr., 813 F.2d 755, 759 (6th Cir. 1987) (holding no state action in private hospital's revocation of staff privileges because connections between state and hospital were too tenuous).

their staff privileges are constructively terminated by the grant of an exclusive contract.[26]

When an exclusive contract constructively terminates an incumbant physician, the physician's first attack should be a failure to provide sufficient due process. Since the Constitution provides for due process protection whenever government action deprives individuals of property or liberty interests, the threshold question concerns the existence of a governmental actor. Once government action is shown, as with a public hospital, a quasi-public entity, or a sufficient state nexus, the battle is over.[27] Of course, with a failure to show government action, as is usually the case in private hospital litigation, state claims such as breach of contract exist as a fall-back offense.

BREACH OF CONTRACT

Hospital Bylaws Fail to Contain the Requisite Elements to be Considered a Contract

A contract has been defined as "an agreement enforceable at law."[28] Documents such as the typical medical staff bylaws seem to create rights and obligations, however such documents do not contain all the necessary elements of a contract. With the increasing use of exclusive physician contracts, most hospital-physician litigation today arises from the termination or expiration of a "contractual" relationship.[29] Typically, med-

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[26] These claims are usually contractual or tortious. *See* Ishak v. Fallston Gen. Hosp. & Nursing Ctr., 438 A.2d 1369, 1371 (1982) (concerning physician alleging that hospital bylaws created contractual right to continued employment); Nashville Mem'l Hosp., Inc. v. Binkley, 534 S.W. 2d 318, 320 (Tenn. 1976) (involving claims of intentional interference with contractual relationship).

[27] Nominal damages may be recovered without proof of actual injury along with compensable damages, if proven, and punitive damages if a malicious deprivation of due process has occurred. Carey v. Piphus, 435 U.S. 247, 265 (1978).

[28] ARTHUR LINTON CORBIN, CORBIN ON CONTRACTS § 1.3 n.2 (Joseph M. Perillo ed. Rev. ed. 1983).

[29] Zellers, *supra* note 1, at 72. Usually, litigation surrounds the hospital's "economic" decision of terminating the hospital-physician relationship. *Id.* at 72, n. 18.

ical staff bylaws cover a variety of topics ranging from the relationship between medical practitioners and the hospital, to the organizing of departments and quality control, including confidentiality, immunity and releases.[30]

Courts differ as to whether hospital bylaws constitute a contract.[31] In cases which construe hospital bylaws as contractual, little discussion, if any, concerns an elementary analysis of contract law.[32] For example, in *Lewisburg Community Hospital v. Alfredson*, the Tennessee Court of Appeals merely stated that if bylaws carried no legal duty then they would be reduced to "meaningless mouthing of words," therefore bylaw provisions must be followed.[33]

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[30] John Hulston et al., *Do Hospital Medical Staff Bylaws Create a Contract*, 51 J. MO. B. 352, 353 (1995). Bylaws encompass the protocol for organizing hospital administration and of course the procedures for adoption and amending the bylaws themselves. *Id.*

[31] Borkon, *supra* note 1, at 161-62 (1996). *See* Monroe v. AMI Hospitals, 877 F. Supp. 1022, 1029 at n.5 (S.D. Tex. 1994) (stating "[U]nder Texas law, a hospital's medical staff bylaws do not constitute a contract between a hospital and its medical staff."); Shulman v. Washington Hosp. Ctr., 319 F. Supp. 252, 255 (D. D.C. 1970) (stating "[T]he Court finds that no contract existed between the hospital and the Plaintiff which would entitle him to relief. There is not a formal or informal agreement which is binding between any physician . . . and the hospital."); Munoz v. Flower Hosp., 507 N.E.2d 360, 365 (Ohio Ct. App. 1985) (stating "[T]he trial court could have reasonably found as a matter of law that the staff bylaws did not constitute a contract between the doctors and the hospital, and therefore, appellee could not be guilty of breach of a non-existent contract."); *but see*, Lawler v. Eugene Wuesthoff Mem'l Hosp. Assoc., 497 So. 2d 1261, 1264 (Fla.Dist.Ct.App. 1986) (stating "Hospital's By-laws, when approved and adopted by the governing board, become a binding and enforceable contract between the Hospital and the physicians comprising the medical staff."); Rees v. Intermountain Healthcare, Inc., 808 P.2d 1069, 1076 (Utah 1991) (stating "bylaws of the hospital are, in essence, a contract between the hospital and the physician"); Terre Haute Reg'l Hosp., Inc. v. El-Issa, 470 N.E.2d 1371, 1377 (Ind.Ct.App. 1984) (stating hospital bylaws formed contract between hospital and its staff members).

[32] *See e.g.*, Lewisburg Community Hosp. v. Alfredson, 805 S.W.2d 756, 759 (Tenn. 1991) (holding that hospital is contractually bound by its bylaws); Brad Dallet, *Economic Credentialing: Your Money or Your Life*, 4 HEALTH MATRIX 325, 338 (1994) (stating that bylaws are contracts that cannot be unilaterally altered).

[33] *Lewisburg*, 805 S.W.2d at 759. In *Lewisburg*, the court rejected the hospital's contention that bylaws do not bind hospitals in a contractual sense. *Id.* The court pointed out the hypocrisy of the hospital's argument that the physicians, but not the hospital, are bound by the bylaws. *Id.*

Lack of Necessary Consideration

It seems as though the proper opinion is similar to the decisions in *Gianetti v. Norwalk Hospital*[34] and *Robles v. Humana Hospital Cartersville*.[35] In *Gianetti* and *Robles*, the courts held that hospital bylaws, under the principles of contract law, do not create an enforceable contract between the hospital and physician.[36] Furthermore, similar to the court's decision in *Gianetti*, the *Robles* court held that since the hospital had a legal duty to develop bylaws and procedures independent of the aggrieved physician, and because only the hospital had the power to change the bylaws, then no contract could exist because of a lack of mutual exchange of consideration.[37] Since most state statutes or regulatory authorities require hospitals to create bylaws, using the *Gianetti* and *Robles* logic, no bargained for exchange exists which a physician can claim.

An alleged contract without mutuality of obligation lacks consideration and is therefore not a contract at all.[38] Mutuali-

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[34] Gianetti v. Norwalk Hosp., 557 A.2d 1249 (Conn. 1989). In *Gianetti*, the physician again asserted that the medical staff bylaws constituted a contract between the hospital and its physicians. *Id.* at 1252. Furthermore, Dr. Gianetti argued that the bylaws served an integral function in the relationship between the physician and the hospital. *Id.* However, the hospital countered by contending that state regulations required medical staff bylaws, and therefore the bylaws did not arise from any specific negotiations with the physician. *Id.*

[35] Robles v. Humana Hosp. Cartersville, 785 F. Supp. 989 (N.D. Ga. 1992). In *Robles*, the court recognized the similar issues of the physician's claim that the hospital bylaws created a contract, and the decisions of both *Lewisburg* and *Gianetti*. *Robles*, 785 F. Supp. at 1000.

[36] Gianetti v. Norwalk Hosp., 557 A.2d at 1253; *Robles*, 785 F. Supp. at 1001-02. In *Gianetti*, the court considered the statutory obligation of the hospital and therefore held the creation of the bylaws to be a pre-existing legal duty owed by the hospital. *Gianetti*, 557 A.2d at 1253. Thus, the hospital bylaws lacked the sufficient "bargained-for-exchange" required for a contract. *Id.*

[37] *Robles*, 785 F. Supp. at 1001-02. In *Robles*, the court stated that "consideration cannot be a promise to do something which the promisor is already obligated to do." *Id.* at 1001.

[38] 17A AM. JUR. 2D *Contracts* § 18 (1991). "[M]ututality of obligation means that a contract must be binding on both parties, so that an action may be maintained by each against the other. . . . [L]ack of mutuality creates a want of consideration." *Id.*

ty of obligation must be present before any bilateral contract is formed. Most jurisdictions have correctly concluded that since members of a medical staff may resign at will or maintain membership without ever treating any patients, a binding agreement or contract does not exist.[39]

In typical litigation concerning exclusive contracts, the central argument of the constructively terminated physician is that once a hospital grants staff privileges the hospital is bound to renew those privileges unless the physician has performed inadequately. On the other hand, the physician is free to come and go without any obligation to the hospital. In essence, the physician "has the cake and eats it too." In the physician's world, the hospital could do nothing even though its patients could be denied essential hospital-based physician service until another physician became available. Therefore, with regard to its most essential contract terms, the disputed contract lacks consideration due to the absence of mutuality of obligation.

Furthermore, hospital bylaws fail to meet the requirements for a contract under Mississippi law because there exists no mutual assent to be bound.[40] A court will not create a contract between two parties where those parties have not manifested a mutual assent to be bound.[41] The "purpose of

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[39] *See generally*, Monroe v. AMI Hosp., 877 F. Supp. 1022, 1029 at n.5 (S.D. Tex. 1994) (stating "[U]nder Texas law, a hospital's medical staff bylaws do not constitute a contract between a hospital and its medical staff."); Shulman v. Washington Hosp. Ctr., 319 F. Supp. 252, 255 (D. D.C. 1970) (holding that no contract exist between hospital and physician due to lack of binding formal or informal agreement); Munoz v. Flower Hosp., 507 N.E.2d 360, 364 (Ohio Ct. App. 1985) (stating "The most enlightened [case holdings] seems to be that staff bylaws can form binding contracts between the doctors and hospital but only where there can be found in the bylaws an intent by both parties to be bound).

[40] Andrew Jackson Life Ins. Co. v. Williams, 566 So. 2d 1172, 1178 (Miss. 1990). In order for a contract to be formed, there must be an offer by one party and a clear, definite and complete acceptance from the other party. Williams v. Favret, 161 F.2d 822, 824 (5th Cir. 1947). For the acceptance to be valid this "mutual assent to be bound" must exist at the time of the contract. *Andrew Jackson Life Ins. Co.*, 566 So. 2d at 1178.

[41] A. Copeland Enter. v. Pickett & Meador, Inc., 422 So. 2d 752, 754 (Miss. 1982). Under Mississippi law, "the test" for determining the existence of an en-

every contract is to bind the parties to performance."[42] Constructively terminated physicians assert the right to practice at a hospital for the remainder of their careers unless those rights were removed for cause after a due process hearing. Clearly, no "meeting of the minds" exists for such an agreement. Therefore, the hospital bylaws fail to create an enforceable contract because of a lack of mutual assent to be bound.

Bylaws Are Analogous to Employee Handbooks

Unlike contracts, employee handbooks tend to be generalized policy statements concerning a broad range of topics and issues.[43] Likewise, hospital bylaws set out policies and procedures for the general, efficient operation of the health care facility. Medical staff bylaws cannot be considered to be inclusive of every detail of operation.

Although usually case specific, courts have generally denied breach of contract suits over employment handbooks.[44]

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forceable contract is "whether the parties have manifested an intention to be bound by its terms and whether the terms are sufficiently definite to be legally enforced." Knight v. Sharif, 875 F.2d 516, 523 (5th Cir. 1989).

[42] 17 C.J.S. *Contracts* § 1(1)(2) (1963).

> A contract has a binding force based on the fact that it evidences a meeting of minds of two parties in good faith, and a contract does not contemplate a right of a party to repudiate it. Contracts mutually entered into between parties having capacity to contract are binding obligations and must not be upset merely at the whim of one party or the other; . . . .

17 C.J.S. *Contracts* § 1 (2) (1963).

[43] Richard L. Alfred & Robert A. Bertsche, *By the Book: Don't Let Your Employee Handbook Tie You Down*, BUS. L. TODAY, Jan./Feb. 1993, at 33. Employers ideally strive to keep their policies flexible to stay competitive. *Id.* Usually, the policies change often and specify that the handbook is not contractually binding. *Id.*

[44] Theresa L. Kruk, Annotation, *Right to Discharge Allegedly "At-Will" Employee as Affected by Employer's Promulgation of Employment Policies as to Discharge*, 33 A.L.R. 4th 120, 123 (1984). *See generally*, Hartle v. Packard Elec., 626 So. 2d 106, 107 (Miss. 1993) (holding that employee handbook did not constitute legal contract or alter at-will status of employment relationship). The court stated:

> We do not believe the listing of causes that "may result in the termination of your employment" in the Sears handbook detracted in any way

In cases which have allowed contractual claims arising from an employment handbook, the litigation usually concerns specific procedures for *discipline*.[45] In contrast, physician termination suits normally arise out of purely economic decisions that have no relationship to hospital disciplining of physicians.

Physicians May Have Remedy Other Than Breach of Contract

With an increase in litigation occurring because of hospitals entering into exclusive contracts, it seems as though the incumbent physician is left without a remedy.[46] However,

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from the language in the application or provided a reasonable basis for the conclusion that the plaintiffs were employed under a "for cause" contract. The fact that certain acts were identified as conduct that might lead to discharge did not indicate that those acts were the exclusive permissible grounds for discharge.

Id. at 110.; Watkins v. United Parcel Serv., Inc., 797 F. Supp. 1349, 1357 (S.D. Miss. 1992)(stating that no Mississippi court has held that policy book or manual, standing alone suffices as express or implied written contract of employment); Sloan v. Taylor Mach. Co., 501 So. 2d 409, 410-11 (Miss. 1987) (holding that employer's policy book did not create express or implied written contract of employment); *but see*, Bobbitt v. The Orchard, Ltd., 603 So. 2d 356, 359, 361 (Miss. 1992) (holding that employer must follow its provisions set out in handbook). The *Bobbitt* decision can be distinguished by the fact that the handbook set forth specific provision for discharging an employee for *specific* acts set out in the handbook, i.e. using alcohol on the premises. *Bobbitt*, 603 So. 2d at 361. Furthermore, the court held that the handbook did not change the at-will nature of employment. *Id.* at 362. The logic used in *Bobbitt* would benefit physicians only if the hospital attempted to discharge a physician for cause. It must be noted however that some jurisdictions have found a contractual relationship created by a handbook, and the recent trend is to scrutinize the totality of the circumstances in its creation in considering the existence of a contract. Alfred, *supra* note 43, at 33.

[45] Pruitt v. Levi Strauss & Co., 932 F.2d 458, 463 (5th Cir. 1991). "Under Texas law, personnel manuals and employee handbooks do not create contractual rights unless the parties *expressly agree* that the procedures contained in these material are binding." *Id.* (emphasis added). In Texas, an exception to the general rule exists when the manual contains detailed discipline procedures, the employer followed these procedures, and the supervisor treated the provisions as a contractual obligation. Aiello v. United Air Lines, Inc., 818 F.2d 1196, 1201 (5th Cir. 1987).

[46] *See* Jane C. Taber & Janna P. King, *Caught in the Crossfire: Economic Credentialing in the Health Care War*, DET. C.L. REV., Winter 1994, at 1179, 1211 (stating "[i]n any event, at present, hospitals may enter into exclusive contract arrangements, reasonably incorporating economic and quality of care consider-

Mississippi courts may choose to follow the reasoning espoused in *Robles* and *Gianetti*. Although the *Robles* court left the physician without a cause of action for money damages, it held that the bylaws in question were judicially enforceable because of the relationship between the hospital and the physician.[47]

Allowing courts to have some type of judicial review in these actions creates an acceptable compromise for both the hospital and the aggrieved physician. However, in jurisdictions which hold that no contractual right is created by medical staff bylaws, most courts simply do not allow any remedy for the physician. Harsh as this may seem, it must be noted that a physician is not obligated under most hospital-physician relationships, thus non liability for a hospital's purely economic decision in these instances is appropriate.

PRACTICAL SUGGESTIONS[48]

This confusion and surrounding litigation could be dispensed with the use of clearly written bylaws coupled with physician contracts specifically setting out the expectations and obligations of the hospital and the physician. In creating or amending[49] hospital bylaws and physician contracts, each

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ations, without undue fear of liability based upon use of the same").

[47] In *Robles*, the court stated:

> The Court does not conclude, however, that the bylaws are not judicially enforceable. The Georgia legislature would not have mandated that the hospital create these procedure, if the legislature had not intended that the hospital follow the procedures once they were implemented. Consequently, if a hospital does not comply with its own procedures, the affected doctor can bring an action to enjoin the hospital from removing him from the staff until the bylaws are fully complied with.

Robles, 785 F. Supp. at 1002.

[48] Whether or not the reader represents the hospital or the physician, a prudent counsel will thoroughly scrutinize the existing employment relationship and bylaws to ensure disputes will not arise in the future.

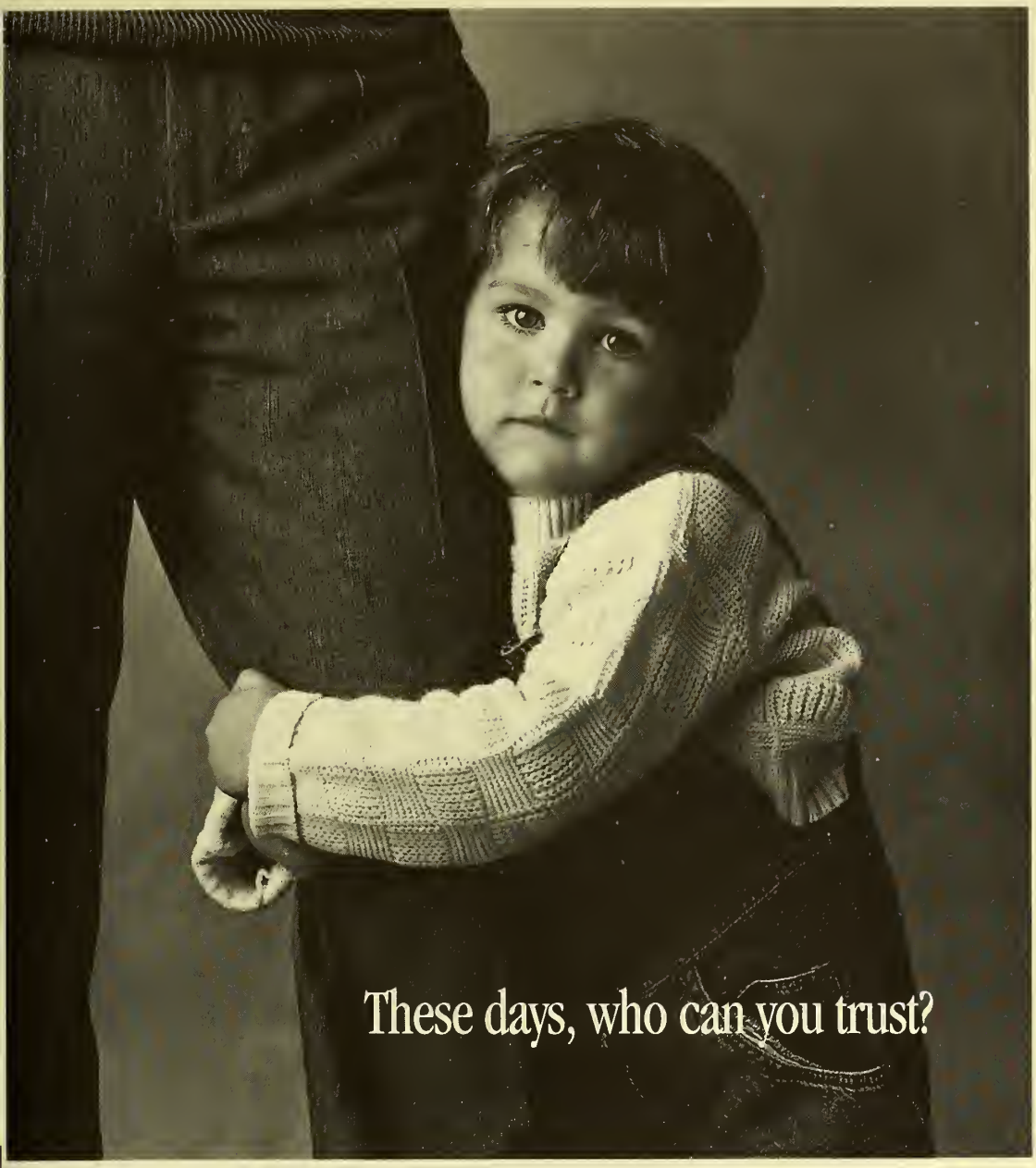
[49] Any amendments should become effective upon the physician's renewal of privileges. Zellers, *supra* note 1, at 86. Since a physician is effectively reapplying for staff privileges, the bylaws could arguably be modified during the renewal period. *Id.*

party should clearly define the rights and limitations of a physician who has been granted privileges, including the use of hospital equipment, facilities, and staff to provide services.

Also, hospital bylaws and physician contracts should grant expressly to the governing board, the power to alter or terminate any health service, including exclusive or direct contracting. Furthermore, both should differentiate between termination for economic reasons and termination for disciplinary or competency reasons. For the latter, due process, including notice and an opportunity to be heard, is required, whereas only a reasonable period of advance notice should be required for termination for economic reasons.

Bylaws should provide that the physician contract will supersede any applicable or conflicting bylaw regarding privileges. Lastly, the contract should specify that hospital privileges terminate automatically upon the expiration of the contract. Hopefully with clearly defined obligations and limitations, the threat of litigation will be reduced.

Charles R. Galloway



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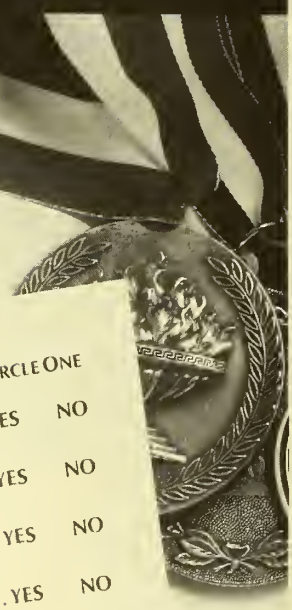

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